In the Supreme Court of the United States

OCTOBER TERM, 1969

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GUARDIAN AGENCY, INC. AND BENEFICIAL INSURANCE AGENCY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Seventh Circuit. This petition is conditional upon the filing and granting of a petition for a writ of certiorari (due for filing on August 7, 1969) in the case of *Local Finance Corporation, et al.* v. *Commissioner,* which involves the same judgments; if such a petition is not filed and granted, we shall seek dismissal of this petition.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (App. C, pp. 20 ff.) are reported at 48 T.C. 773. The opinion of the court of appeals (App. A, pp. 7–18) is reported at 407 F. 2d 629.

357-930—69——1

JURISDICTION

The judgment of the court of appeals was entered on February 28, 1969 (App. B, p. 19). On May 13, 1969, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including July 25, 1969. The juridiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Assuming *arguendo* that the court of appeals erred in allocating one half of the income from credit life insurance premiums to Local Finance Corporation and its subsidiaries under Section 482 of the Internal Revenue Code, whether such amounts should then be allocated to Guardian Agency, Inc., and Beneficial Insurance Agency, Inc.

STATUTE INVOLVED

Section 482 of the Internal Revenue Code of 1954 (26 U.S.C. 482) provides as follows:

> ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, appor-

tionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

STATEMENT

This is a consolidated income tax case for the years 1958 through 1962 involving Section 482 of the Internal Revenue Code. Section 482 empowers the Commissioner of Internal Revenue to allocate income among business enterprises controlled by the same interests "if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such * * * businesses." Taxpayers Guardian Agency, Inc. ("Guardian"), and Beneficial Insurance Agency, Inc. ("Beneficial"), are general insurance brokers and are respectively parent corporation and wholly-owned subsidiary. Stockholders who owned in excess of 70 percent of the stock of the Local Finance Corporation, a finance company, owned 100 percent of the stock of Guardian. Local Finance had several wholly-owned subsidiaries which also conducted similar finance company business.

In connection with the loans made by the finance companies, single premium credit life insurance was offered to the borrowers. The insurance was sold by employees of Local Finance who prepared the necessary papers. Initially, the insurance was issued by an independent life insurance company which paid Local Finance a commission roughly equal to one half of the net premiums. Subsequently, Local Finance assigned the commission income to Guardian which, together

with Beneficial and Local Finance Corporation, performed certain of the accounting duties incident to the sale of the insurance.

After July 1, 1958, a new arrangement was devised whereby Grand National Life Insurance Company ("Grand National") was organized. All the stock of Grand National was owned by the shareholders of Guardian. Grand National thereupon entered into a reinsurance agreement with the independent insurance company which had previously issued the credit life insurance for borrowers from Local Finance. This reinsurance agreement provided that Grand National was to receive 90.5 percent of all premiums received. Under the new arrangement, employees of Local Finance continued to sell the insurance and prepare the necessary papers, and employees of Guardian and Beneficial continued to perform certain of the accounting duties incident to the sale of the insurance. Grand National conducted no activity other than contracting for reinsurance; as in the previous arrangement, the supervision and payment of al claims were to be handled by the independent insurance company.

The Commissioner allocated one half of the premium income to Local Finance and its subsidiaries, acting under Section 482, and determined deficiencies accordingly. For protective purposes, the Commissioner also asserted deficiencies against Guardian and Beneficial by means of a similar allocation of premium income.

The Tax Court upheld the Commissioner's determination that one half of the premium income was

allocable to Local Finance and its subsidiaries; it thus did not reach the Commissioner's alternative allocation. *Local Finance Corporation* v. *Commissioner*, 48 T.C. 773. Local Finance and its subsidiaries appealed to the Court of Appeals for the Seventh Circuit, and the Commissioner took protective cross-appeals for review of the decisions in favor of Guardian and Beneficial. On February 28, 1969, the court of appeals affirmed the decisions of the Tax Court. Local Finance and its subsidiaries sought rehearing, which the court denied on April 9, 1969. On June 27, 1969, Mr. Justice Marshall granted Local Finance and its subsidiaries an extension of time until August 7, 1969, in which to petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

This petition is filed to protect the revenue in the event that this Court grants the petition for a writ of certiorari which we understand Local Finance Corporation and its subsidiaries intend to file.[1] If, as we believe, the courts below correctly held that one half of the credit life insurance premium income should be included in the income of Local Finance and its subsidiaries, then those courts properly determined that Guardian and Beneficial were without any tax liability for the years involved. If, however, this Court were to grant certiorari and rule that the Commissioner's allocation of premium income to Local Finance and its subsidiaries was erroneous, then the Court should remand the case for determination of

[1] The Commissioner intends to oppose such a petition if it is filed.

the alternative contention of the Commissioner, not passed upon by the courts below, that one half of the premium income should be allocated to Guardian and Beneficial.

CONCLUSION

If this Court should grant the petition for a writ of certiorari to be filed by Local Finance Corporation and its subsidiaries in *Local Finance Corporation, et al.* v. *Commmissioner,* this petition should also be granted; if certiorari is there denied, or no petition is filed, we shall take action pursuant to Rule 60 for the dismissal of this petition.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JULY 1969.

APPENDIX A

In the United States Court of Appeals for the Seventh Circuit

September Term, 1968—September Session, 1968

Nos. 16840–16850, Inclusive

LOCAL FINANCE CORPORATION; LOCAL FINANCE CORPORATION OF SOUTH MARION; LOCAL FINANCE CORPORATION OF ELKHART; LOCAL FINANCE CORPORATION OF GAS CITY; LOCAL FINANCE CORPORATION OF RUSHVILLE; LOCAL FINANCE CORPORATION OF DANVILLE; LOCAL FINANCE, INC.; LOCAL FINANCE CO., INC., OF GARY; LOCAL FINANCE COMPNY, INC., PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT APPELLEE

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT APPELLANT

v.

GUARDIAN AGENCY, INC., BENEFICIAL INSURANCE AGENCY, INC., PETITIONERS-APPELLEES

February 28, 1969

Petitions for Review of a Decision of the Tax Court of the United States.

Before SWYGERT, FAIRCHILD and KERNER, *Circuit Judges.*

SWYGERT, *Circuit Judge.* We are asked to review a decision of the Tax Court upholding the assessment of

income tax deficiencies by the Commissioner of Internal Revenue.[1] This case presents the question whether the Tax Court was correct in holding that the Commissioner's allocation to the petitioners, Local Finance Corporation and its subsidiaries, pursuant to his authority under INT. REV. CODE of 1954, § 482,[2] of one-half of the credit life insurance net premiums paid by borrowers from these corporations was not arbitrary or unreasonable. Federal income taxes for the years 1958 through 1962 in the amount of $418,977.31 are in question.

The facts are largely undisputed and have been set forth in the Tax Court's opinion reported at 48 T.C. No. 76 (Aug. 31, 1967). We will only recite the facts which are necessary for a basic understanding of the financial interrelationships which existed between the various corporate taxpayers involved in this appeal. Taxpayers are Indiana corporations which, during the years in question, engaged in the business of making small and industrial loans. Local Finance Corporation is the parent corporation and all the other named

[1] In addition, the Commissioner also petitions for review on the basis that if this court reverses the decisions of the Tax Court with respect to the income allocation to Local Finance and its subsidiaries, the cause should be remanded for consideration of the Commissioner's alternative allocation to Guardian Agency, Inc. and Beneficial Insurance Agency, Inc.

[2] Section 482 provides:

"In any case of two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

finance company taxpayers are wholly owned subsidiaries of Local Finance.

Taxpayers, Guardian Agency, Inc. and Beneficial Insurance Agency, Inc., are respectively parent and wholly owned subsidiary. They were organized as general insurance brokers to provide fire and casualty insurance coverage on property given as security to Local Finance by its borrowers. The finance companies were virtually the entire source of their fire and casualty business. During the years in question, stockholders who owned in excess of seventy per cent of Local Finance's stock also owned all the stock of Guardian and its subsidiary Beneficial.

In connection with the loans made by the finance companies, credit life insurance was offered to their borrowers for a term which was coextensive with the contractual term of the related indebtedness. Although not required to do so, about ninety per cent of the borrowers took out credit life insurance. This insurance was written by Old Republic Life Insurance Company, an unrelated concern, at a rate of one dollar per year per $100 of coverage. Such rate was commonly charged in the credit life insurance industry in Indiana and its reasonableness is not at issue. Since it was customary for insurance companies to pay a commission for the sales of such insurance, the rate of premium charged by Republic was fixed in an amount sufficient to provide for such commission.

During the period January 1 through June 30, 1958, the commissions on the credit life insurance sold to borrowers from the finance companies were not paid directly to the finance companies. Rather, such commissions were paid pursuant to an agreement entered into between Republic and Don H.

Miller, who was an officer of each of the finance companies. The agreement provided that Miller should act as agent for Republic and receive a fixed commission of forty per cent of the net premiums paid by the borrowers from the finance companies, that Republic should retain nine and a half per cent of such net premiums to cover its overhead and profit, and that Miller should receive an additional contingent commission measured by the remainder of the net premiums after payment of all claims. Miller simultaneously executed an assignment of such commissions to Guardian. The commissions so assigned to Guardian over the period ending June 30, 1958 amounted to about fifty-six per cent of total net premiums.

After June 30, 1958, Republic continued to write the insurance on the lives of the borrowers from the finance companies, but no commissions, as such, were paid to Miller. Instead, Republic entered into an agreement with Grand National Life Insurance Company, an Arizona corporation, which was controlled by the finance companies and Guardian, whereby Grand National agreed to reinsure the risks and receive ninety and a half per cent of the net premiums, Republic retaining nine and a half per cent of the net premiums. Over the period July 1, 1958 through December 31, 1962, the proceeds which Grand National received, after provision for payment of the claims, amounted to about fifty-eight per cent of the total net premiums. Grand National also had some operating expenses, but in relatively small amounts.

It was the contention of the Commissioner before the Tax Court that a portion of the commission income received by Guardian and Beneficial during the period January 1 to June 30, 1958 and a portion of the reinsurance premiums received by Grand National

during the period July 1, 1958 to December 31, 1962 constituted compensation actually earned by the finance companies for selling and processing the credit life insurance, and therefore should be allocated to them in proportion to the amount of insurance which each finance company sold. The amounts allocated by the Commissioner equaled fifty per cent of the total net premiums received by the finance companies throughout the taxable years in question. The Tax Court upheld the Commissioner's allocation and deficiency assessment and found that fifty per cent of the net premiums were taxable to the finance companies under sections 61 and 482 of the Internal Revenue Code.

The taxpayers make two principal contentions: that the finance companies did not earn or have sufficient control over the premium income from the insurance to be taxed thereon and that the Tax Court's decision conflicts with prior cases holding that a taxpayer is not taxable on income he does not receive and is prohibited by law from receiving. In reviewing the Commissioner's allocation and the Tax Court's determination, our inquiry is a limited one. *Ballentine Motor Co.* v. *Commissioner,* 321 F. 2d 796 (4th Cir. 1963). When evaluating section 482 situations, the Commissioner is empowered to examine closely the transactions between controlled taxable entities in order to determine whether they are such as would have been consummated in an arm's length negotiation between strangers and to make an allocation when they fail to meet that standard. *Eli Lilly Co.* v. *United States,* 372 F. 2d 990, 1000 (Ct. Cl. 1967); *Oil Base, Inc.* v. *Commissioner,* 362 F. 2d 212, 214 (9th Cir. 1966). Because of the Commissioner's broad discretion to appraise the factual situation, his determination under section 482 "is essentially one of fact

and * * * must be affirmed if supported by substantial evidence." *Advance Machinery Exchange* v. *Commissioner,* 196 F. 2d 1006, 1007–08 (2d Cir. 1952).

The two primary elements which must exist to sustain a section 482 allocation are the existence of commonly controlled companies and the earning of income by certain of these companies which is the absence of the Commissioner's reallocation would not adequately be reflected in the income they would otherwise report for federal income tax purposes.

The goal of the statutory allocation procedure is to insure that controlled taxpayers are placed on a parity with uncontrolled taxpayers. Turning first to the question of common control, there is no doubt that during the years at issue Local Finance, Guardian, Beneficial, and Grand National were controlled by the same interests within the meaning of section 482. The common shareholder interests previously described make it clear that the "control" requirements have been met.[3]

The more difficult inquiry is whether the finance companies and insurance companies would have entered into the same arrangements had they been uncontrolled corporations and bargained at arm's length. This question can be resolved only by determining who actually earned the commission premiums. The undisputed evidence in the record shows that during the entire period employees of the finance companies performed most of the services incident to the sale and servicing of the insurance. It is well known that insurers pay policy solicitors a portion of the premium as a commission for generating and processing the insurance. The touchstone of our analysis is who expended the effort which caused the policies to be

[3] *See Treas. Reg.* § 1.482–1(a)(3) (1967).

issued. The record demonstrates that it was the finance companies who advised the borrowers of the opportunity to obtain life insurance and encouraged them to subscribe.[4] The finance companies wrote the policies, collected the premiums and deposited them in the bank accounts of Guardian and Beneficial, made refunds, prepared the necessary papers in the event of the death of an insured borrower, and made weekly reports to Guardian and Beneficial. The sole function of the latter companies was to collate and transmit information and premiums to Old Republic.[5] The Commissioner's allocation had the effect of compensating the finance companies for their efforts in generating and processing the life insurance. Despite the fact that the commissions were diverted to Guardian and Grand National during the period in question, it is clear that neither entity earned the commissions. Because the record indicated that Beneficial received commissions amounting to fifty-six per cent of the net premiums, from January 1 to June 30, 1958 and Grand National received for the remainder of the years in issue about fifty-eight per cent of the net premiums by its reinsurance of the risks, the Commissioner's allocation of only fifty per cent of the net premiums to the taxpayers is reasonable.

The taxpayers argue that the finance companies did not earn the insurance commissions because they performed only routine paper work. Although it is our

[4] The record establishes the finance companies' expertise in this regard. Although the borrowers were not required to purchase credit life insurance, eighty-five to ninety-five per cent of them did so.

[5] No contention is made that Grand National, the reinsurer, was not a valid business entity; our holding rests on an application of income-earning criteria to the taxpayers' activities.

holding that the record supports the Tax Court's determination that the taxpayers did in fact earn the commissions, even if it was true that the finance companies did little to earn the commissions, it does not follow that the premium income should be regarded as belonging to the controlled insurance companies. However little the finance companies did to earn this money, they performed those minimal services which were the *sine qua non* of the insurance business. It cannot be seriously contended that Guardian or Grand National did anything that entitled them to a greater portion of the net premiums representing the commissions.

That the finance companies did not actually receive the premium proceeds which the Commissioner attributed to them does not prevent taxation. This proposition is settled by the assignment of income doctrine set forth in *Lucas* v. *Earl,* 281 U.S. 111 (1930).[6]

The taxpayers contend that the Commissioner's allocation is precluded by state law. Indiana law apparently forbids finance companies from receiving any income other than interest from loans, although there has been no judicial interpretation of the statutory language cited by the finance companies.[7] We are of

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[6] *See also Kimbrell* v. *Commissioner*, 371 F. 2d 897, 902 n.15 (5th Cir. 1967), where the fact that direct receipt of the income would probably have been illegal did not prevent the income from being taxed to the individual who earned and controlled it.

[7] The taxpayers ground their state law argument on Indiana's Small Loan Law, Burns Ind. Stats. Ann. § 18–3002 (1964) which provides in part:

"In addition to the rate of interest or charges herein provided for no further or other charge or amount whatsoever for examination, service, brokerage, commission, expense, fee, or bonus or other thing or otherwise shall be directly or indirectly charged, contracted for, or received. * * *

the opinion that regardless of the status under Indiana law of the taxpayers' arrangements, the Commissioner is not precluded from making his allocation, since the criteria of what constitutes income under section 61 and the appropriateness of an allocation under section 482 are matters of federal law. Federal taxing statutes apply their own criteria of what constitutes income. In *Burnet* v. *Harmel,* 287 U.S. 103, 110 (1932), the Supreme Court observed: "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the Constitution, to tax income. The exertion of that power is not subject to state control. * * * State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." None of the exceptions enumerated by the Court in *Burnet* which require invocation of state law are presented in the instant case. Section 482 by its terms makes no express reference to state law. If the taxpayers' state law argument is logically extended, it would lead to the erroneous conclusion that no income the payment or receipt of which is prohibited by state law can be included in gross income for federal income tax purposes. *See, e.g., James* v. *United States,* 366 U.S. 213 (1961).

The final argument relied upon by taxpayers is that the Tax Court's decision conflicts with prior authorities. Specifically, the taxpayers cite *Nichols Loan Corp.* v. *Commissioner,* 21 T.C.M. 805 (1962), *rev'd,* 321 F. 2d 905 (7th Cir. 1963), *Campbell County State Bank, Inc.* v. *Commissioner,* 37 T.C. 430 (1961), *rev'd,* 311 F. 2d 374 (8th Cir. 1963), and *L. E. Shunk Latex Products, Inc.* v. *Commissioner,* 18 T.C. 940 (1952). Although these cases closely resemble the ones before us, none of them is contrary to the result

reached here. *Nichols* involved a loan and insurance arrangement whereby these activities were handled by two separate entities. Unlike the instant case, there was no finding by the Tax Court that the commissions would have been payable to the finance companies but for a special arrangement deflecting them to the insurance partnership. Furthermore, there was no finding that the partnership had not earned the insurance commissions.[8] Finally, there was no finding in *Nichols* that the finance companies earned or controlled the disposition of the commission income although this court did hold that the cost of providing services in connection with the sale of insurance was an ordinary and necessary business expense deductible by the finance companies.

The *Campbell Bank* case presented a bank-insur-

[8] We agree with Judge Tannenwald's observation in his concurring opinion in the Tax Court proceeding in the instant case:

"In none of the cases relied upon by petitioners, with one possible exception, did the taxpayer in fact perform the services for which the allocated payments were made. In each, as petitioners themselves point out on brief, the taxpayer was simply in "the position to have performed the services for which the income was paid out but chose not to do so." At best, those cases stand for the proposition that the mere possibility of performance of services by the taxpayer does not sustain an allocation of payment by respondent. They do not hold that taxability cannot be imposed where the taxpayer actually performs the services. The possible exception is Nichols Loan Corporation of Terre Haute, T.C. Memo. 1962–149, reversed on other grounds 321 F. 2d 905 (C.A. 7, 1963). But it is significant that neither in the opinion of this Court nor that of the Court of Appeals was there any reference to section 482 and the opinion of this Court makes clear that its decision was based on a "consideration of all evidence." In any event, if that case can be viewed as requiring a contrary result herein, I would not follow it."

ance partnership relationship. The Tax Court rejected the Commissioner's contention that the insurance agency was a sham and refused to attribute its income to the bank. In the instant case there is no claim that the insurance companies are shams, but additionally the Tax Court found that the finance companies earned the commission income. Contrary to the facts before us, in *Campbell Bank* the Eighth Circuit specifically noted that the services performed by the bank in connection with the insurance were minimal. Additionally, the insurance company was the source of compensation for those people located at the bank who devoted their full efforts to the insurance work.

In the *Shunk* case, the Tax Court held that an allocation under the predecessor provision of section 482 was unreasonable because the price charged by taxpayers for their products to a controlled partnership distributor was fixed by the Office of Price Administration and could not have been raised to the level contained in the Commissioner's income allocation. The critical element in *Shunk* was that the taxpayer could not have raised its price, whether to a controlled or wholly independent distributor. Contrary to the taxpayers' assertion here, the *Shunk* case does not stand for the proposition that if a particular item of income cannot be legally earned on account of provisions of a nonfederal tax statute, it cannot be reported as federal taxable income. Section 482's predecessor was inapplicable in *Shunk* because there was no need to implement the section's policy of placing a controlled corporation on a parity with an uncontrolled one. The OPA regulations in *Shunk* prevented the generation of the income which the Commissioner sought to allocate; here Indiana law merely

prohibited the receipt of the commission income by the finance companies.

Since it is our holding that the decisions in Nos. 16840 through 16848 should be affirmed, we need not reach the issues raised by the Commissioner in Nos. 16849 and 16850.

The decision of the Tax Court is affirmed.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX B

JUDGMENT

United States Court of Appeals for the Seventh Circuit

Friday, February 28, 1969

Before

Hon. LUTHER M. SWYGERT, *Circuit Julge*
Hon. THOMAS E. FAIRCHILD, *Circuit Judge*
Hon. OTTO KERNER, *Circuit Judge*

LOCAL FINANCE CORPORATION, ET AL., PETITIONERS-APPELLANTS

Nos. 16840 thru 16848

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

COMMISSIONER OF INTERNAL REVENUE, PETITIONER-APPELLANT

Nos. 16849, 16850

vs.

GUARDIAN AGENCY, INC., BENEFICIAL INSURANCE AGENCY, INC., PETITIONERS-APPELLEES

Petitions for Review of a Decision of the Tax Court of the United States

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on October 25, 1967, be, and the same is hereby, AFFIRMED, in accordance with the opinion of this Court filed this day.

APPENDIX C

In the Tax Court of the United States

Dockets Nos. 1693–65—1703–65

Filed August 31, 1967

LOCAL FINANCE CORPORATION, ET AL., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Max E. Meyer, Stephen A. Milwid, Wilbur S. Legg, and *John K. O'Connor,* for the petitioners.

Dennis J. Fox, for the respondent.

ATKINS, *Judge:* The respondent determined deficiencies in the petitioners' income tax as follows:

Docket No.	Petitioner	Taxable year	Deficiency
1693–65	Local Finance Corp.	1958	$60,190.09
		1959	56,492.22
		1960	75,958.84
		1961	65,136.00
		1962	67,582.00
1694–65	Local Finance Corp. of South Marion	1961	2,724.00
		1962	773.00
			4,058.57
1695–65	Local Finance Corp. of Elkhart	1959	1,327.26
		1960	380.68
1696–65	Local Finance Corp. of Gas City	1958	529.61
		1959	557.85
		1960	632.00
		1961	368.00
		1962	385.76
1697–65	Local Finance Corp. of Rushville	1958	523.36
		1959	690.55
		1960	604.00
		1961	669.00
		1962	175.57
1698–65	Local Finance Corp. of Danville	1960	1,150.00
		1961	478.00
		1962	
1699–65	Local Finance, Inc.	1958	2,251.89
		1959	3,354.15
		1960	4,406.10
		1961	3,172.00
		1962	4,108.00
1700–65	Local Finance Co., Inc. of Gary	1958	394.79
		1959	1,890.14
		1960	1,269.58
		1961	234.00
		1962	1,365.00
1701–65	Local Finance Co., Inc.	1958	4,341.05
		1959	10,253.35
		1960	15,742.90
		1961	11,392.00
		1962	13,416.00
1702–65	Guardian Agency, Inc.	1958	17,781.82
		1959	42,283.41
		1960	52,681.68
		1961	44,500.00
		1962	48,366.00
1703–65	Beneficial Insurance Agency, Inc.	1958	4,297.21
		1959	18,097.12
		1960	20,120.50
		1961	16,312.00
		1962	19,026.00

The parties having agreed upon one of the issues in docket Nos. 1693–65 and 1701–65 and the respondent having conceded error with respect to one of the issues in docket No. 1693–65, the issues remaining for decision are (1) whether, for the period January 1 to

June 30, 1958, the respondent erred in allocating to the petitioners in docket Nos. 1963–65 through 1701–65, pursuant to sections 61 and 482 of the Internal Revenue Code of 1954, a portion of the income reported by the petitioners in docket Nos. 1702–65 and 1703–65 as commissions on sales of credit life insurance, and (2) whether, for the period July 1 to December 31, 1958, and for the taxable years 1959 through 1962, he erred in allocating to such petitioners a portion of the income reported by Grand National Life Insurance Co. as premiums for reinsurance of credit life insurance. In the alternative there is also the issue of whether, for such latter period and taxable years, such portion is allocable to the petitioners in docket Nos. 1702–65 and 1703–65.

FINDINGS OF FACT

Some of the facts were stipulated and the stipulations are incorporated herein by this reference.

The petitioners are corporations organized under the laws of the State of Indiana, having their principal offices at 333 West Fourth Street, Marion, Ind. They filed their Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Indianapolis, Ind.

The petitioners Local Finance Corp. of South Marion, Local Finance Corp. of Elkhart, Local Finance Corp. of Gas City, Local Finance Corp. of Rushville, Local Finance Corp. of Danville, Local Finance, Inc., Local Finance Co., Inc. of Gary, and Local Finance Company, Inc., are wholly owned subsidiaries of Local Finance Corp. (hereinafter called Local Finance). Collectively, Local Finance and its subsidiaries will sometimes be referred to as the finance companies.

During the years in question, the finance com-

panies were engaged in the business of making small loans. Local Finance and its five subsidiaries at South Marion, Elkhart, Gas City, Rushville, and Danville were licensed under the Indiana Small Loan Act [1] and the Indiana Retail Installment Sales Act.[2] The other three finance company petitioners were licensed under the Indiana Industrial Loan and Investment Act.[3] The greater dollar volume of business of the finance companies collectively was derived from loans made, at the maximum rate of interest permitted, under the Indiana Small Loan Act. Under that Act the loan to any one borrower was limited to $500. The finance companies making loans under the Indiana Industrial Loan and Investment Act voluntarily limited their loans to $1,000 to any one borrower.

The petitioner Guardian Agency, Inc. (hereinafter referred to as Guardian), was formed in 1936 as a general insurance agency and broker to provide fire and casualty insurance coverage on property given as security to the finance companies by their debtors, and the finance companies were virtually the entire source of its fire and casualty business. In the years in question stockholders who owned in excess of 70 percent of the stock of Local Finance also owned 100 percent of the stock of Guardian.

The petitioner Beneficial Insurance Agency, Inc. (hereinafter referred to as Beneficial, is the wholly owned subsidiary of Guardian, having been acquired by Guardian in 1956, and was engaged in the same business.

None of the petitioners has ever been authorized in writing by any life insurance company to act as an

[1] Ind. Ann. Stat. secs. 18–3001 through 18–3005 (1964).
[2] Ind. Ann. Stat. secs. 58–901 through 58–945 (1964).
[3] Ind. Ann. Stat. secs. 18–3101 through 18–3125 (1964).

agent in connection with the writing or selling of any life insurance policies, nor has any been licensed by any State as a life insurance agent. Section 39–4608 of Burns Indiana Statutes Annotated provides that no corporation shall act in Indiana as an agent for a life insurance company and that no life insurance company shall pay a commission to any person who is not entitled to act as agent.

In connection with, and as an incident to, the loans made by the finance companies, credit life insurance was offered to their debtors for a term which was coextensive with the contractual term of the related indebtedness. The finance companies did not require that their debtors take out credit life insurance, but in the years involved 85 percent to 95 percent of them did so. Since before 1936 the finance companies have offered credit life insurance to their borrowers for several business and economic reasons, including the following: (1) Their competitors generally offer credit insurance, (2) the insurance is an important factor in obtaining repayment of the loans, and (3) collection on the insurance policies, rather than collection from a coobligor (usually the obligor's spouse) is more favorable to public relations.

Credit life insurance, as referred to herein, is single-premium term insurance on the life of a debtor in an amount at least sufficient to discharge the debt in case of the debtor's death. Such insurance may be written on either an individual or a group policy basis. In the former case the debtor is the policyholder, and the creditor is the first beneficiary, while in the latter case the creditor is the policyholder as well as first beneficiary. Also, two types of coverage are generally provided under credit life insurance: (1) Decreasing term coverage, under which the amount of the death benefit decreases during the pol-

icy term coincidentally with the decrease in the amount of the debt under the applicable installment payments schedule; and (2) level term coverage, under which the amount of the death benefit remains constant during the policy term.

Since January 1954 the credit life insurance issued to all but an insignificant number of debtors of the finance companies was single-premium decreasing-term insurance, written on an individual policy basis. The single premium was paid at the inception of the coverage.

After World War II it became common practice for life insurance companies to pay compensation for credit life insurance sold to debtors of lending institutions. Such compensation consisted of a commission equal to a fixed percentage of the premium charged, and sometimes, in addition, a contingent commission based upon the insurer's later-determined loss ratio. Where the insurance was issued pursuant to a group policy held by the lending institution such contingent commissions were paid in the form of retroactive premium adjustments. Later, a practice was adopted by some lending institutions whereby the lending institution would form a life insurance company in a State where capital requirements for insurance companies were low and have such company reinsure the risks to the original insurer and receive reinsurance premiums.

Prior to January 1954, Lincoln National Life Insurance Co. (hereinafter called Lincoln) issued the credit life insurance sold to debtors of the finance companies. This insurance was issued under a group policy held by Local Finance. Lincoln paid a percentage commission on this business. The commissions were paid to Guardian, rather than to Local

Finance, because Local Finance had been advised by its attorney that it could not accept any commissions or income from the insurance business since Indiana law precluded small loan companies from receiving any income other than from small loan interest.[4] As the volume of such insurance increased an arrangement was made whereby Lincoln would pay contin-

[4] During the years in question sec. 18–3002 of Indiana Statutes Annotated (Small Loan Act) provided in part:

"In addition to the rate of interest or charges herein provided for no further or other charge or amount whatsoever for examination, service, brokerage, commission, expense, fee, or bonus or other thing or otherwise shall be directly or indirectly charged, contracted for, or received, except the lawful fees, if any, actually and necessarily paid out by the licensee to any public officer for filing, recording, or releasing any instrument securing the loan in any public office, which fees may be collected when the loan is made, or at any time thereafter. If any interest, consideration or charges in excess of those permitted by this act are charged, contracted for or received the contract of loan shall be void and the licensee shall have no right to collect or receive any principal, interest, or charges whatsoever."

Sec. 18–3004 provided in part:

"Any licensee and any person acting as an officer or employee of a licensee, who shall violate any of the provisions of section 2 [§ 18–3002] of this act shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than five hundred dollars [$500] or by imprisonment of not more than six [6] months or by both such fine and imprisonment in the discretion of the court."

Sec. 18–3001 provided that a license may be revoked if, among other things, the licensee has violated any provision of the act or any rule or regulations lawfully made thereunder.

The Indiana Industrial Loan and Investment Act and the Indiana Retail Installment Sales Act also made provision for the fixing of maximum interest or charges and provided certain penalties in the event of violations of the Acts or any regulations thereunder.

gent commissions (retroactive premium adjustments) over and above the percentage commissions already being paid to Guardian. Lincoln insisted that such contingent commissions would necessarily have to be paid to Local Finance as the policyholder. One check for such contingent commissions was issued to Local Finance. Local Finance, for the same reason stated above with respect to the percentage commissions, felt that it should not accept these contingent commissions. Lincoln was willing to pay the contingent commissions to Guardian if Local Finance would execute an assignment of the commissions to Guardian, but Local Finance was not satisfied that such an arrangement would be a satisfactory solution to the problem. It approached other credit life insurers, including Old Republic Life Insurance Co. of Chicago, Ill. (hereinafter called Republic), a company which was not affiliated with the petitioners in any way.

On January 4, 1954, Don H. Miller, who was an officer of each of the finance companies and of Guardian, executed an agreement with Republic which provided that Miller was to be Republic's agent for soliciting credit life insurance on the lives of debtors of the finance companies. It was provided that the insurance to be written should be single-premium decreasing-term insurance written on an individual policy basis, that the amount of insurance in any case should not exceed $500 on any one life, and that the insurance should be written only on the lives of persons who were 65 or under and who appeared to be in sound health and were actively employed. The premium charged by Republic was $1 per year per $100 of coverage, which was the rate which had been charged by Lincoln and was the rate commonly charged in the

credit life insurance industry in Indiana.[5] In fixing its rates for credit life insurance Republic took into account the expected mortality costs, the administration expenses, the direct acquisition costs (which included principally any commissions paid for generating the business), and a profit margin. Local Finance selected Republic as the insurer because Republic was willing to retain less of the premiums than another insurer which Local Finance was considering.

In the above agreement Republic agreed to pay Miller a guaranteed commission of 40 percent of the premiums collected plus, at 3 month intervals, an additional commission equal to the balance of premiums collected remaining after subtracting the sum of 12 percent[6] of the premiums to be retained by Republic for overhead and profit, the 40-percent guaranteed commission previously paid, the net refunds made, losses paid, and unpaid claims outstanding. Any deficit resulting would be accumulated and charged against future contingent commissions, but would not affect the 40-percent guaranteed commission. Either party could terminate the agreement on 30 days' notice.

On the same date, January 4, 1954, Miller executed an assignment to Guardian of all commissions which

[5] During the years 1958 through 1962 an insurance company could write credit life insurance, on a decreasing-term basis, on the lives of finance company debtors in Indiana between the ages of 21 and 65 at a premium rate of not more than 50 cents per $100 of coverage per year, without taking into consideration the payment of commissions. Such a premium would be sufficient to cover death claims, which would amount to approximately 30 cents per $100 of coverage per year, administration expenses, and a profit margin.

[6] On Oct. 1, 1957, the agency agreement was amended to decrease the amount of premiums retained by Republic from 12 to 9½ percent, effective Oct. 1, 1957.

might become due him under the agency agreement for a stated consideration of $1 "and other good and valuable considerations." On January 13, 1954, Miller, as vice president of Local Finance, wrote Republic, notifying it of the assignment and directing it to make commission checks under the agency agreement payable to Guardian.

From 1954 through 1962 the premium charged by Republic did not change. The finance companies' debtors paid the full premiums at the inception of the coverage out of the loan proceeds. In the event a loan was paid off in advance, in some instances the insurance was terminated and a refund of the premiums allocable to the unexpired term of the loan was made. If a loan was refinanced by a new loan, and new credit insurance was written on the new loan, the insurance premium paid on the old loan was either refunded or was credited toward the premium on the new insurance.

In each of the Indiana branch offices of the finance companies there was at least one employee who held a license as an Indiana life insurance agent for Republic. These employees signed the individual policies issued to the debtors. At first the licensees were office girls in the branch offices. However, in more recent years the managers of the branch offices have been the licensees. When a licensed employee was not available at a branch office, an employee of Guardian, also licensed as an agent by Republic, signed the policies. These employees did not receive any payments from Republic for acting as agents, nor did they receive additional pay from the finance companies.

Whenever a customer of one of the finance companies applied for a loan, the employee of the finance company interviewing the customer would discuss the availability of credit life insurance. If the customer

agreed to take credit life insurance, both the loan papers and credit life insurance papers were prepared by the employees of the branch office. Any refunds of premiums paid for credit life insurance were handled by such branch office employees. In the event of death of an insured debtor the branch office through which the policy was sold would complete a claim form, attach to it a death certificate, and forward this to Guardian or Beneficial which would check the computations and forward the form to Republic for payment.

Credit life insurance premiums received by each branch office of the finance companies were segregated by the branch office employees and deposited from time to time during each week in a separate bank account in the branch office city in the name of Guardian or Beneficial. Once a week the insurer's copies of the register sheets, evidencing the issuance of the insurance policies, were forwarded from the branch offices to either Guardian or Beneficial for transmission to Republic. Guardian of Beneficial prepared a monthly report to Republic showing the amount of premiums collected on policies issued, the amount of premiums returned on policies canceled, and the amount of the difference. From such difference Guardian or Beneficial withheld the guaranteed 40-percent commission and transmitted a check for the remainder, together with the monthly report, to Republic.[7] The contingent commissions, which were paid every 3 months, were paid by Republic directly to Guardian or Beneficial.

The finance companies also placed and handled fire and casualty insurance written through Guardian and

[7] Although Miller executed no written assignment of commissions to Beneficial, commissions were received by Beneficial on credit insurance reported through it to Republic.

Beneficial, the paperwork being more extensive than that involved in handling credit life insurance, and received no compensation therefor from Guardian or Beneficial.

Under date of September 18, 1956, the insurance commissioner of the State of Indiana issued a directive to corporate insurance agencies, which stated, in pertinent part, as follows:

> Whereas, there is some evidence to indicate that some corporate insurance agents have violated the law of Indiana which prohibits a corporate agency from acting as a life insurance agent; and
>
> Whereas, the illegal device sometimes used to accomplish such violations is to employ an individual life licensee and to take an assignment of his commissions; and
>
> Whereas, it is now declared that the assignment or transfer of life insurance commissions by a licensed life agent to a corporate insurance agency which employes [sic] such life agent is illegal; and
>
> Whereas, it is now further declared to be illegal for any corporate agency officer or employee who is a licensed life agent to assign or transfer life insurance commissions to any corporation, foreign or domestic, which holds or controls the employer corporate agency;
>
> Now, Therefore, it is directed that any corporate insurance agency which receives life insurance commissions by way of assignment or transfer, or in any other form, from or through an officer or employee who is a licensed life agent or which permits any employees or officer who is a licensed life agent to assign or transfer life insurance commissions in any form to any holding corporation which control the said corporate agency shall forthwith have its license as an agent in the State of Indiana revoked permanently.

> This Directive does not condone or legalize any device not herein described which violates the aforesaid law prohibiting any corporate agency from acting as a life insurance agent.

In view of the above directive Republic was concerned as to the legality of the procedure by which commission payments were assigned by Miller to Guardian and Beneficial. It felt that the finance companies relied heavily upon it for advice as to procedures which would preclude any difficulty with any State agency. It accordingly brought this directive to the attention of Miller. Miller was concerned that the continuance of the assignment of commissions by him to Guardian and Beneficial might jeopardize the latter companies' insurance agency licenses. Republic was also concerned with the possibility that as a result of the assignment procedure its license as an insurance company might be suspended or revoked, and that Miller might lose his agency license. Various possible arrangements were considered by Republic and Local Finance, including the possibility of licensing the stockholders of Local Finance as agents and paying the commissions to them or the forming of a partnership consisting of such stockholders and the payment of commissions to the partnership. However, neither of these plans was feasible because there were too many shareholders of Local Finance, and no basic change in procedure was made at that time. The only change made at that time was that, beginning in November 1956 and continuing through June 30, 1958, Republic paid the contingent commissions by check made payable to Miller, instead of directly to Guardian or Beneficial, and Miller endorsed the checks over to Guardian and Beneficial. Guardian and Beneficial

continued to withhold and retain the 40-percent guaranteed commissions.[8]

In the latter part of 1957 Republic suggested to Local Finance that it would be advisable to form a life insurance company to reinsure life insurance policies issued by Republic with respect to debtors of the finance companies. Its primary purpose in recommending the reinsurance procedure was to retain the credit life insurance business generated by the finance companies and at the same time avoid any possible violation of Indiana law with respect to the payment of commissions. Under such an arrangement Republic would continue to retain a portion of the premiums but would shift the mortality risks to the reinsurer.

After discussions among the directors of Local Finance and Guardian and officials of Republic, it was decided that such a life insurance company should be formed, but Local Finance's attorney advised that such company should not be owned by Local Finance. It was also decided that since Guardian and its subsidiary, Beneficial, had been receiving the commissions derived from the credit life insurance sold to the debtors of the finance companies, the stockholders of Guardian should be offered the opportunity to become the shareholders of the new insurance company.

Thereafter on March 18, 1958, there was incorporated under the laws of the State of Arizona a corporation under the name of Grand National Life Insurance Co. (hereinafter called National). The new insurance company was incorporated under Arizona

[8] Miller did not report any of the commissions on his Federal income tax returns. Such commissions were reported as part of the gross income of Guardian and Beneficial.

law because that State permitted low minimum capitalization. On June 25, 1958, National obtained from the State of Arizona a certificate of authority as a life insurance company. It issued 661 shares of stock (par value of $40 per share) at a price of $60 per share (a total of $39,660, representing $26,440 of paid-in capital and $13,220 of paid-in surplus). Each stockholder of Guardian was entitled to the same number of shares of National stock as was held by him in Guardian. The shareholders of Guardian acquired 655 of the 661 issued and outstanding shares of National. Miller, who was not a stockholder of Guardian, acquired the other 6 shares. The stockholders of Guardian paid for their stock in National in cash. A special dividend of $40 per share was paid by Guardian in order that its stockholders might avail themselves of the opportunity of acquiring such stock.

On July 21, 1958, National and Republic entered into an agreement entitled "Reinsurance Treaty No. 1," whereby National assumed Republic's liability for losses on credit life insurance written by Republic on or after July 1, 1958, on the lives of debtors of the finance companies. Such agreement provided in part as follows:

ARTICLE II

> Within twenty (20) days after the receipt by OLD REPUBLIC of any premium paid by or on behalf of policy holders for said policies, OLD REPUBLIC shall pay to GRAND NATIONAL a premium equal to ninety and one-half percent (90½%) of the total premium received by OLD REPUBLIC on said policies issued in the previous month.

ARTICLE III

Together with each payment of premium, OLD REPUBLIC shall furnish to GRAND NATIONAL a statement giving the following information for the preceding month:

1. The total premiums on all said policies written during the preceding month.

2. The total premiums returned on policies surrendered for cancellation during the said month.

3. Life Insurance Account Number of Policies and amount of insurance.

a. Issued during the preceding month

b. Surrendered for cancellation during said month

c. Terminated by death during said month

d. Expired during said month

e. In force at the end of said month

4. Claims paid including allocated claim expenses (allocated claim expenses shall include all expenses incurred in handling, adjusting, or defending claims, excepting ordinary office expenses of OLD REPUBLIC and wages or salaries of employees of OLD REPUBLIC).

ARTICLE IV

In remitting the premiums under Article II OLD REPUBLIC may deduct (a) ninety and one-half percent (90½%) of refunded premiums on said policies and (b) the amount of incurred losses as shown by the statement or OLD REPUBLIC may request separate reimbursement for such items by GRAND NATIONAL.

ARTICLE V

GRAND NATIONAL will maintain proper reserves against policies reinsured under this treaty, provided, such reserves shall in no event

be less than $2.64 per $1,000.00 of reinsurance assumed by GRAND NATIONAL under this treaty.

* * * * *

ARTICLE VII

The supervision and payment of all claims under said policy shall be handled by OLD REPUBLIC. The liability of GRAND NATIONAL shall follow the liability of OLD REPUBLIC in accordance with the terms and conditions of said policies.

The above contract was terminable by either party upon 60 days' notice. National maintained a separate corporate existence during all the years involved herein and was subject to regulation by the Department of Insurance of the State of Arizona. Its operations were confined to the reinsurance acquired under the treaty between it and Republic. A reinsurer has no contractual relationship with the policyholders ordinarily of the ceding insurer. National had no dealings with any of the debtors of the finance companies.

National's home office consisted of space in a room in an office occupied by an attorney, James Engdahl, in Phoenix, Ariz. National had two accounts in a Phoenix bank where cash and securities belonging to it were deposited by Engdahl. It had no claims department, underwriting department, or salaried employees except Engdahl, who acted as office manager and received $20 a month. Consulting actuaries in Chicago kept National's books of account, computed its reserves, and prepared its annual statements to the Arizona insurance department. During the years involved five of National's six directors were also five of the six directors of Local Finance and Guardian, and, except for 1 year, a majority of its officers also

constituted a majority of the officers of those companies.

After the reinsurance arrangement went into effect on July 1, 1958, there was little or no change in the procedures followed in the sale and servicing of the credit insurance issued on the lives of the finance companies' debtors, as compared with the procedures which had been followed during the period from January 1954 to June 1958. Branch office employees of the finance companies, as agents of Republic, continued writing policies, collecting premiums and depositing them in the names of Guardian and Beneficial, making refunds, preparing necessary papers in the event of the death of an insured debtor, and making reports to Guardian and Beneficial. Guardian and Beneficial continued to check the computations received, file monthly reports to Republic, and transmit the amount of net premiums to Republic without, however, withholding any amount as commissions. After July 1, 1958, no commissions were paid to Miller, Guardian, Beneficial, or any of the petitioners with respect to insurance written by Republic after June 30, 1958, on the lives of debtors of the finance companies.[9] After the execution of the reinsurance treaty Republic continued to handle the payment of death claims as before. It maintained a cash reserve fund, set up out of the net insurance premiums sent to it through Guardian and Beneficial, and paid the death claims out of such fund. From the net premiums received Republic each month deducted the death claims paid, the refunds made, and the 9.5

[9] The finance companies continued, as before, to place and handle fire and casualty insurance policies written through Guardian and Beneficial without receiving any payment therefor from those agencies.

percent of premiums retained, and sent the balance directly to National.

During the 5 taxable years in question the total number of credit life insurance policies processed was 266,772. Neither Guardian, Beneficial, nor the finance companies had to hire additional employees, purchase extra equipment, or provide additional space to process the credit life insurance, but did incur additional costs for postage.[10]

In 1960 an accounting under the agency agreement was furnished by Republic to Miller showing that from May 1, 1954, until June 30, 1958, the net premiums (gross premiums less premium refunds) on credit life insurance policies covering the finance companies' debtors amounted to $581,687.38. The amount of guaranteed commissions and contingent commissions received by Guardian and Beneficial was $232,674.96 and $94,306.98, respectively, or a total of $326,981.94, which amounted to about 56 percent of the net premiums. Out of the remaining $254,705.44 (about 44 percent of net premiums) Republic paid claims of $186,338.56 and expenses of $221.38 (or a total of $186,559.94), and retained $68,145.50.

During the period from July 1, 1958, to December 31, 1962, the total net premiums (gross premiums less refunds) received by Republic on credit life insurance sold to the debtors of the finance companies amounted to $1,254,748. Of this amount Republic retained $119,201 (or 9.5 percent). Against the remain-

[10] Taking into account a reasonable allocation of salaries paid by the finance companies, and the extra cost of postage incurred, the cost to the finance companies of selling and servicing the credit life insurance policies during the years 1958 through 1962 was about $60,000. On a similar basis the cost to Guardian and Beneficial of processing the credit life insurance policies over the period July 1, 1958, through Dec. 31, 1962, was about $11,000.

ing $1,135,547 [11] (or 90.5 percent) to which National was entitled under the reinsurance agreement, there were chargeable claims costs in the total amount of $402,195.06 (or about 32.1 percent of net premiums). National also had operating expenses, such as rent, professional fees, etc., in the taxable years 1958 through 1962 in the respective amounts of $979.90, $1,652.49, $1,754.11, $1,841.70, and $2,563.32.

During the taxable years 1958 through 1962 National paid dividends in the total amount of $267,044. For those years it and the petitioners filed separate income tax returns, reporting separate corporate incomes. National filed its returns as a life insurance company, reporting taxable income in the respective amounts of $27,088.12, $127,591.51, $211,794.02, $113,885.25, and $115,829.25. For those years it paid taxes in the respective amounts of $8,585.82, $47,532.03, $84,018.70, $53,720.33, and $53,917.37.

National was subject to, and was under the supervision of, the Department of Insurance of Arizona. It was examined by that department for the period March 18, 1958, to December 31, 1962. The report of the examination contained no criticism of its operations.

The following tabulation shows, for each of the taxable years involved, the net credit life insurance premiums (gross premiums less refunds) received and deposited in the insurance premium bank accounts by each of the finance companies (and by some of the Local Finance's subsidiaries against whom no deficiencies were determined) and the amount thereof which Guardian and Beneficial each received:

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[11] This amount was accounted for by National on its annual statements of insurance operations as gross premiums on reinsurance received as follows: 1958 (from July 1), $113,504.47; 1959, $257,920.36; 1960, $261,834.67; 1961, $245,680.74; and 1962, $256,606.81.

	1958		1959	1960	1961	1962
	To 6/30/58	From 7/1/58				
Local Finance Corp.	$65,898.58	$83,437.39	$186,617.44	$201,440.90	$183,172.49	$186,285.24
Local Finance Co., Inc.	8,154.63	8,549.01	32,350.77	46,698.69	41,650.07	49,611.24
Local Finance Co., Inc. of Gary	1,174.92	1,132.45	6,728.39	5,787.60	3,801.83	6,967.34
Local Finance, Inc.	4,215.98	4,445.12	12,900.60	16,946.53	12,199.77	15,798.65
Local Finance Corp. of Danville			575.07	2,884.11	2,436.13	2,505.53
Local Finance Corp. of Elkhart	[2] 3,019.69	[2] 3,498.58	6,245.41	6,198.37	[2] 5,402.61	[2] 4,467.03
Local Finance Corp. of Gas City	1,165.82	1,372.05	3,530.67	3,718.96	2,961.89	2,724.77
Local Finance Corp. of Rushville	1,158.64	1,578.27	3,513.39	4,627.95	4,024.10	4,463.23
Local Finance Corp. of South Marion	[2] 491.35	[2] 667.26	[2] 2,976.44	3,735.28	4,150.85	3,974.32
Local Finance Corp. of Delphi [1]			657.61	1,986.58	1,873.87	2,356.56
Local Finance Corp. of Kokomo [1]					1,801.61	2,240.97
Local Finance Corp. of Monticello [1]		814.19	1,997.18	2,283.92	2,348.45	2,385.32
Local Finance Corp. of Muncie [1]					1,437.07	2,722.70
Local Finance Corp. of Portage [1]					242.44	1,896.02
Totals	85,279.61	105,494.32	258,092.97	296,308.89	267,503.18	288,398.92
Guardian Agency, Inc.	54,184.69	69,049.29	176,466.82	203,453.87	186,795.86	197,084.85
Beneficial Insurance Agency, Inc.	31,094.92	36,445.03	81,626.15	92,855.02	80,707.32	91,314.07
Totals	85,279.61	105,494.32	258,092.97	296,308.89	267,503.18	288,398.92

[1] Listed only for completeness. No deficiencies proposed.
[2] No deficiencies proposed for these taxable years.

In the notices of deficency the respondent, relying upon sections 61, 269, and 482 of the Internal Revenue Code of 1954, allocated as income among Local Finance and its subsidiaries (including subsidiaries not involved herein) 50 percent of the above net premiums handled by them in the taxable years 1958, through 1962. He also, alternatively, determined that 50 percent of the amount so handled during the period July 1 to December 31, 1958, and during 1959 through 1962 was allocable to Guardian and Beneficial. He made no allocation to Guardian and Beneficial with respect

to the period January 1 to June 30, 1958, since those two companies had already reported as income commissions received during such period.

OPINION

Throughout the years in question herein the finance companies, in connection with the making of their small loans, made available to their debtors, on a voluntary basis, credit life insurance written by Republic, an unrelated insurance company, at a rate of $1 per year per $100 of coverage. Such rate was the rate commonly charged in the credit life insurance industry in Indiana. It was customary for insurance companies to pay a commission for the sales of such insurance and the rate of premium charged by Republic was fixed in an amount sufficient to provide for such commission.

During the period January 1 through June 30, 1958, the commissions on the credit life insurance sold to debtors of the finance companies were not paid directly to the finance companies. Rather, such commissions were paid pursuant to an agreement entered into between Republic and Don H. Miller, who was an officer of each of the finance companies. The agreement provided that Miller should act as agent for Republic and receive a fixed commission of 40 percent of net premiums (gross premiums less refunds) paid by debtors of the finance companies, that Republic should retain 9.5 percent of such net premiums to cover its overhead and profit, and that Miller should receive an additional contingent commission measured by the remainder of the net premiums after payment of all claims. Miller simultaneously executed an assignment of such commissions to Guardian, a corporation con-

trolled by the same interests which controlled the finance companies. The commissions so assigned to Guardian (some of which were received by Guardian's subsidiary Beneficial) over the period from May 1, 1954, through June 30, 1958, amounted to about 56 percent of total net premiums.

After June 30, 1958, Republic continued to write the insurance on the lives of debtors of the finance companies, but no commissions, as such, were paid to Miller or any of the petitioners. Rather, Republic entered into an agreement with National, an insurance company organized under the laws of Arizona and controlled by the same interests which controlled the finance companies and Guardian, whereby National agreed to reinsure the risks and receive 90.5 percent of the net premiums, Republic retaining 9.5 percent of net premiums. Over the period July 1, 1958, through December 31, 1962, the amount which National received, after provision for payment of claims, amounted to about 58.4 percent of the total net premiums. National also had some operating expenses but in relatively small amounts.

It is now the primary position of the respondent that a portion of the commission income received by Guardian and Beneficial during the period January 1 to June 30, 1958, and a portion of the reinsurance premiums received by National during the period July 1, 1958, to December 31, 1962, constituted compensation earned by the finance companies for selling and processing the credit life insurance, and should be allocated to them in proportion to the amount of insurance which each sold. The amounts allocated by him amount to 50 percent of the total net premiums throughout the taxable years 1958 through 1962. He

relies upon both sections 61 [12] and 482 [13] of the Internal

[12] Sec. 61 of the Code provides in part as follows:

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

[13] Sec. 482 of the Code provides as follows:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Sec. 1,482–1 of the Income Tax Regulations provides in part:

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. * * * The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by

Revenue Code of 1954. He specifically disclaims any reliance upon section 269 of the Code.

The petitioners concede that the loans made by the finance companies created the market for the credit life insurance issued by Republic to their debtors and that the officers and directors of such finance companies "could to a certain extent control who would receive income from the insurance." They state, however, that under the Indiana loan laws under which the finance companies operated they were precluded from receiving any monetary compensation from such insurance, and that they never did receive any of the compensation. They further state that their control over the disposition of the income was limited in that the insurance laws of the State of Indiana prohibited the payment of income in the form of commissions on life insurance to corporations. They further state that the procedures which they adopted were designed to assure that the finance companies would not receive any income from the insurance in violation of Indiana law, and that such procedures must be given effect in determining to whom any such income should be taxed. They therefore contend that the respondent's determination that there should be allocated to the finance companies a portion of the commissions paid during the period January 1 to June 30, 1958, and a portion of the reinsurance premiums paid during the period July 1, 1958, to December 31, 1958, and during the years 1959 through 1962 was unreasonable, arbitrary, and capricious, and should not be sustained.

At the outset it should be stated that there is no

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inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

question that all the finance companies as well as Guardian, Beneficial, and National are owned or controlled by the same interests within the meaning of section 482. The respondent having determined that the allocations in question are necessary in order to prevent evasion of taxes or clearly to reflect the income of the finance companies, the burden of proof is upon the petitioners to prove that such allocations are erroneous. In *Grenada Industries, Inc.*, 17 T.C. 231, affd. (C.A. 5) 202 F. 2d 873, certiorari denied 343 U.S. 819, we stated with regard to section 45 of the Internal Revenue Code of 1939, predecessor to section 482 of the Internal Revenue Code of 1954:

> It has been said many times that the Commissioner has considerable discretion in applying section 45, and that the determinations required of him under the statute must be sustained unless that discretion has been abused. Our review of those determinations is not *de novo,* and we may reverse them only where the taxpayer proves that they are unreasonable, arbitrary, or capricious. See, e.g. *G.U.R. Co.* v. *Commissioner,* (C.A. 7), 117 F. 2d 187, 189; *National Securities Corp.,* 46 B.T.A. 562, 564, affd. (C.A. 3) 137 F. 2d 600, 602, certiorari denied 320 U.S. 794; *Seminole Flavor Co.,* 4 T.C. at 1228.

See also *Spicer Theatre, Inc.,* 44 T.C. 198, affd. (C.A. 6) 346 F. 2d 704; *Pauline W. Ach,* 42 T.C. 114, affd. (C.A. 6) 358 F. 2d 342, certiorari denied 385 U.S. 899; and *Hamburgers York Road, Inc.,* 41 T.C. 821.

For reasons set forth hereinafter it is our conclusion that the respondent's determination was not unreasonable, arbitrary, or capricious and must be sustained.

Section 61 of the Code provides that gross income means all income from whatever source derived, in-

cluding compensation for services, including commissions. It is well established that compensation may be taxed to the earner, despite anticipatory arrangements in contracts designed to prevent such compensation when paid from vesting in the one who earned it (*Lucas* v. *Earl,* 281 U.S. 111); that the power to dispose of income is the equivalent of ownership of it and that the exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it (*Helvering* v. *Horst,* 311 U.S. 112); and that the taxing statutes are not so much concerned with the refinements of title as with the actual command over the income which is taxed and that it makes no difference that such command may be exercised through the creation of a new controlled interest or a subservient agency (*Griffiths* v. *Helvering,* 308 U.S. 355, and cases cited therein). In *Grenada Industries, Inc., supra,* we stated that while undoubtedly the general provisions of the Internal Revenue Code are sufficient to charge the income to the one who actually earns it, in the case of organizations under common control the detailed provisions of section 45 of the 1939 Code (now section 482 of the 1954 Code) "explicitly authorized the commissioner to unscramble any such situation, so that income may be charged to the organization that earned it."

It is clear that throughout the taxable years involved herein the finance companies performed all the services in connection with the sale and servicing of the insurance. It was their employees who contacted the debtors with respect to the taking out of the insurance. They wrote the policies, collected the premiums and deposited them in bank accounts in the names of Guardian and Beneficial, made refunds, prepared the necessary papers in the event of the death

of an insured, and made weekly reports to Guardian and Beneficial. The record shows that Guardian and Beneficial merely collated information prepared by the finance companies and forwarded such information, together with the net premiums (after deducting commissions in the period January 1 to June 30, 1958), to Republic. They did not act as agents of Republic in the sale of the credit life insurance and indeed could not, since under Indiana law corporations could not act as life insurance agents.

While individual employees of the finance companies, rather than the finance companies themselves, were designated as the authorized insurance agents of Republic, it is clear that they were not entitled to any compensation from Republic in their individual capacities for placing the insurance. During the period that commissions were payable to Miller under his contract with Republic, it is obvious that Miller was not acting on his own behalf in entering into the agreement with Republic, but on behalf of the finance companies, that he was not entitled to retain the commissions, and that his assignment of such commissions to Guardian was dictated by Local Finance on behalf of itself and its subsidiary finance companies.[14] We think it must be concluded, therefore, that during the period January 1 to June 30, 1958, the finance com-

[14] This is clearly established by the testimony of Miller. On cross examination he testified in part:

"Q. Why did you decide to give that money up by assigning it away?

"A. I think I would have to answer you this way: that had I not been willing to assign that commission away, I wouldn't have had the agreement to start with. I don't believe that the people that operate Local Finance Corporation would permit an employee to have income from business that they generate without assigning it some place. It's just impractical."

panies earned, and controlled the disposition of, the commission income, and that Miller received the commission income as an agent for such finance companies, which exercised their power to dispose of such income by having Miller assign it to Guardian and Beneficial. The allocation of 50 percent of net premiums to them is not unreasonable in view of the fact that over the period from May 1, 1954, to June 30, 1958, the commissions actually paid amounted to about 56 percent of net premiums.

As pointed out above, commencing July 1, 1958, no commissions, as such, were paid by Republic to anyone with respect to credit life insurance issued to debtors of the finance companies. Instead, the interests controlling Local Finance and Guardian decided to set up National to reinsure the credit life insurance issued to such debtors. The rate charged by Republic, which, as stated above, included a built-in portion normally used to pay commissions for selling the insurance, did not change. Such rate had been sufficient to permit the payment of commissions equal to about 56 percent of net premiums collected by Republic during the period May 1, 1954, to June 30, 1958. There was no change in the procedures followed by the finance companies or Guardian and Beneficial or Republic in the sale of the credit insurance. The finance companies continued to sell and service the insurance as before, and Republic continued to retain the same proportion of net premiums, 9.5 percent, which it had retained in the period January 1 to July 1, 1958.

It is axiomatic that questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and that when applying the income tax laws regard must be had to matters of substance and not mere form. *Weiss* v. *Stearn,* 265 U.S. 242; and *John M. Rogers,*

44 T.C. 126, affd. (C.A. 9, 1965) 377 F. 2d 534. And, as stated in *Comtel Corporation* v. *Commissioner*, (C.A. 2) 376 F. 2d 291, "The Tax Court had the power—indeed the duty—to look to the substance" of the transaction. We think that, in substance, the arrangement made by Local Finance with Republic whereby Republic, instead of paying commissions as such, paid National 90.5 percent of net premiums as reinsurance premiums represented, in part, the exercise by the finance companies of the control they possessed over the disposition of the compensation they earned for selling and servicing the insurance.[15] That is to say, a portion of the reinsurance premiums received by National in reality constituted commission income which the finance companies had earned and which they gratuitously diverted to National. National performed no services in connection with the sale of

[15] Arthur J. Cade, who was executive vice president of Republic during the years involved, testified:

"Q. * * * could you tell me, please, why it was that Old Republic did not seek to place the reinsurance with one of the existing reinsurance companies as opposed to setting up a whole new company?

"A. Yes, sir, there would have been nothing to reinsure.

"Q. Why would there had been nothing to reinsure?

"A. Well, the purpose of utilizing reinsurance here was to create—one of the purposes was to create a legal vehicle to enable us to pay compensation in connection with the procurement of the insurance. If we chose to reinsure some—with some unrelated reinsurance company that result would not have been possible and therefore, I see no reason why we would have kept getting the business."

He also testified that, as an alternative to reinsurance with National, consideration had been given to having the stockholders of Local Finance licensed as insurance agents, either individually or as a partnership, and having them receive the commissions directly, but that such approach was rejected as impractical due to the relatively large number of stockholders.

the insurance. It is true that National was a bona fide insurance company, that it did assume liability for reinsurance of the policies written by Republic, and that it was entitled to compensation for assuming such reinsurance risk.[16] During the period July 1 to December 31, 1958, and during the taxable years 1959 through 1962 National received 90.5 percent of all net premiums and, after provision for all claims, still retained about 58.4 percent of all net premiums. The respondent allocated 50 percent of net premiums to the finance companies, leaving National about 8.4 percent. Here again, for reasons stated above, we think that the allocation of 50 percent of net premiums to the finance companies as compensation for selling and servicing the insurance is not unreasonable. And there is no evidence in the record to show that the approximately 8.4 percent of net preminums remaining with National after the respondent's allocation did not constitute adequate compensation for its reinsurance of the risks and the minimal expenses it incurred.

The petitioners cite, among other cases, *R. P. Crowley,* 34 T.C. 333; *Alabama-Georgia Syrup Company,* 36 T.C. 747, reversed on another issue (C.A. 5) 311 F. 2d 640; and *Campbell County State Bank, Inc.,* 37 T.C. 430, reversed on another issue (C.A. 8) 311 F. 2d 374, for the proposition that the exercise of control over who shall perform services giving rise to income does not justify attribution of the income to the controlling taxpayer. The principle established by those cases, however, has no application here with respect to compensation earned by the finance companies. The finance companies did not designate any other person

[16] While National's total capitalization upon its organization was less than $40,000, this apparently satisfied the insurance laws of Arizona.

to sell and service the insurance and thereby earn commission income. They continued to sell and service the insurance and had the power, which they exercised, over the disposition of the compensation therefor. Of course National performed the service of reinsuring the risks and the compensation for that service may not be attributed to the finance companies. As pointed out above, the respondent's allocation leaves about 8.4 percent of net premiums as income to National, and there is no showing that such amount is not adequate compensation for the reinsurance. And it may be added that although Guardian and Beneficial continued to render incidental services in connection with the processing of the credit life insurance, this did not entitle them to any commission income. This service was rendered under a reciprocal arrangement whereby the finance companies placed and handled for those companies, free of charge, fire and casualty insurance.

The petitioners have shown that the arrangement prevailing in the period January 1 to June 30, 1958, whereby the commissions were paid to Miller instead of to the finance companies was adopted, upon advice of their attorney, in order to avoid violation, or possible violation, of the Indiana statutes under which they were licensed and which fixed the rates to be charged for loans, and that the reinsurance plan prevailing thereafter was adopted for the same reason and also to meet the requirement of Republic, which wanted to avoid violation of the Indiana statute which prohibited payment of life insurance commissions to corporations. They contend that tax avoidance or evasion was not the purpose. The respondent apparently does not question this. However, as pointed out by the respondent, his authority under section 482 is not limited to allocations necessary "to prevent

evasion of taxes," but also includes allocations necessary "clearly to reflect the income" of commonly controlled organizations. We agree that establishment by the petitioners of a nontax motive for the procedures adopted is no answer to the respondent's determination that the allocations were necessary "clearly to reflect" the petitioners' income. In *Asiatic Petroleum Co., Ltd.,* 31 B.T.A. 1152, affd. (C.A. 2) 79 F. 2d 234, certiorari denied 296 U.S. 645, we stated:

> attempted evasion is not the only situation described as proper for invoking section 45. Another is "in order * * * clearly to reflect the income of any of such trades or businesses."

And in *Dillard-Waltermire, Inc.* v. *Campbell,* (C.A. 5) 255 F. 2d 433, it was stated:

> The appellant undertook to prove absence of a tax motive in order to negative the claim of tax evasion. Even satisfactory proof of a business reason * * * would not be an answer to the Commissioner's claimed right to make the allocation. The statute permits such allocation if the result more clearly reflects the true income of the related businesses. * * *

See also *Simon J. Murphy Co.,* 22 T.C. 1341, reversed on other grounds (C.A. 6) 231 F. 2d 639; *Eli Lilly & Co.* v. *United States,* (Ct. Cl.) 372 F. 2d 990; and sec. 1.482–1(c), Income Tax Regs. Since the finance companies performed all the work of selling and servicing the insurance and earned the right to compensation therefor and had the power of disposition over such income, we think it necessary to allocate such income to them in order clearly to reflect their income.

The petitioners insist, however, that the finance companies did not actually receive any commission income, that receipt of any such commissions would have violated the law of the State of Indiana, and

that therefore no such commission income may be allocated and taxed to them.[17]

We find it unnecessary to determine whether direct receipt of the insurance commissions by the finance companies would have violated the Indiana Statutes under which they operated, namely, the Indiana Small Loan Act, the Indiana Retail Installment Sales Act, and the Indiana Industrial Loan and Investment Act.[18] Even if so, and even though the insurance laws of Indiana prohibited payment by a life insurance company of commissions to a corporation, we are of the opinion that the respondent is not foreclosed from allocating to the finance companies under section 482 of the Code the income which they earned and over which they exercised the power of disposition. It is well established that Congress establishes its own criteria for the application of tax statutes, that State law may control only when the Federal taxing act by

[17] The petitioners cite in this connection *Nichols Loan Corporation of Terre Haute*, T.C. Memo. 1962–149, reversed on another issue (C.A. 7) 321 F. 2d 905; *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, reversed on another issue (C.A. 8) 311 F. 2d 374; *First Security Bank* v. *United States*, (D. Mont.) 213 F. Supp. 362, affd. (C.A. 9) 334 F. 2d 120; and *L. E. Shunk Latex Products, Inc.*, 18 T.C. 940.

[18] Although the respondent has not specifically conceded the petitioners' contention in this respect, he presented no argument with respect thereto. No authority has been cited by the parties upon this question. The only case which we have found which deals with the legality of receipt of commissions by a small loan company is *State* v. *Bankers Finance Corporation*, (Del. 1942) 26 Atl. 2d 220. It was there held that the receipt of commissions by a small loan company on insurance on its debtors' collateral did not constitute an "additional charge of any kind" under the Delaware Small Loan Act, where the insurance premium rate was not in excess of the standard rate and the purchase of the insurance was on a voluntary basis.

express language or necessary implication makes its operation dependent upon State law, and that in the absence of language evidencing a different purpose, a tax statute should be interpreted so as to give a uniform application to a nationwide scheme of taxation. *Burnet* v. *Harmel,* 287 U.S. 103; *Lyeth* v. *Hoey,* 305 U.S. 188; *Commissioner* v. *Tower,* 327 U.S. 280; *Helvering* v. *Northwest Steel Rolling Mills, Inc.,* 311 U.S. 46; and *Walter I. Geer,* 28 T.C. 994.

As pointed out above, the exercise of the power to dispose of income and procure the payment thereof to another is, for Federal tax purposes, the equivalent of realization of the income. Clearly, the broad language of section 482 of the Code permits the allocation to a controlled organization of income which it does not actually receive where such allocation is necessary in order clearly to reflect the income of such organization, and there is no indication that Congress intended that the application of that section (or section 61) should be dependent upon State law. Under the circumstances here presented we cannot conclude that the respondent acted unreasonably in making the allocation to the finance companies.

We have carefully examined the cases cited by the petitioners, set forth in footnote 17, *supra,* but conclude that they do not support the proposition that, because the finance companies did not actually receive the commission income and because receipt thereof would have, or might have, violated Indiana law, no such income may be allocated and taxed to them.

In *Nichols Loan Corporation of Terre Haute,* T.C. Memo. 1962–149, we held that the petitioners (Indiana corporations) which conducted loan businesses under the Indiana Small Loan Act were not taxable on credit life insurance commissions, pointing out that they did not intend to, and did not in fact, act as insurance

agents in violation of Indiana law. However, the facts there were quite different from those in the instant case. There the individuals who were stockholders and officers of the corporations had been engaged, prior to the organization of the corporations, in both the business of making loans and the insurance agency business, in partnerships. When the corporations were set up they transferred only the loan businesses to the corporations, and retained the insurance agency businesses. They, in the conduct of their insurance agency business, sold the insurance on the lives of the debtors of the corporations, and received in their own right the commissions. This was the decisive factor in that case. The corporations had no right to the commissions or any power over the disposition thereof. In the instant case the individual officers and employees of the finance companies had no right to commission income or the power to dispose of it. The finance companies earned compensation for selling and servicing the insurance and had the power to dispose of it, which power they exercised in favor of other commonly controlled corporations which had not acted as insurance agents in the sale of the insurance and who did nothing to earn such compensation. In short, there was no person other than the finance companies who was entitled to such compensation or who had the right to dispose of it. It may be added that the application of section 482 was not an issue in the *Nichols* case.

In *Campbell County State Bank, Inc.,* v. *Commissioner,* 37 T.C. 430, the stockholders of a bank formed a partnership to engage in a general insurance agency business, rather than use their bank for that purpose because State law forbade banks to engage in such business. The Commissioner attacked the separate existence of the insurance agency as a sham

and attributed its income to the bank. We there held that the separate identity of the insurance agency should be recognized. We stated that the State statute was relevant only to show the existence of some business purpose (other than the saving of taxes) for conducting the insurance through an entity other than the bank. It may be added that we there also stated that the income earned by the insurance agency could not be allocated to the bank under section 482. In that case it was the fact that the bank did not earn the income, and not the prohibition of State law, which precluded the application of section 482.

First Security Bank v. *United States,* 213 F. Supp. 362 (D.C. Mont.), involved in a similar situation and a similar holding, except that, as pointed out by the Court of Appeals for the Ninth Circuit, in affirming the lower court, section 482 was not in issue.

In *L. E. Shunk Latex Products, Inc.,* 18 T.C. 940, the taxpayers were two manufacturing corporations which, together with a partnership to which they sold their products, were owned or controlled by the same interests. In Janaury 1942 the partnership increased its prices for the goods sold, but the taxayers did not make an increase in their prices to the partnership. Later the Office of Price Administration issued certain wartime price regulations which permitted the increase in prices made by the partnership, but prohibited any increase in prices charged by the taxpayers on their manufactured products above the prices existing at December 1, 1941. The prices that the taxpayers had charged the partnership at that date had been fixed in arm's length negotiations. We there held that section 45 of the Internal Revenue Code of 1939 did not authorize the Commissioner to allocate any of the partnership's income to the taxpayers. We there stated that the OPA regulations

prohibited taxpayers from receiving the very income sought to be attributed to them and that the Commissioner had no authority to attribute to them income which they could not have received. This statement, however, must be considered in the light of the situation there prevailing. The price charged was not due to the control element. The taxpayers could not legally charge any greater amount for their goods, whether to a controlled organization or anyone else, and in fact did not do so. They therefore had no income over which they could exercise the power of disposition. The income which the respondent attempted to allocate to them was not their income, but that earned by the partnership and owned by it.

On brief the petitioners state that the respondent has not reduced the income of National as a correlative adjustment to the income he proposes to tax the finance company petitioners and contend that, as shown by the respondent's own pronouncement contained in a techical information release, T.I.R. 838, August 2, 1966 (published in 7 C.C.H. 1966 Stand. Fed Tax Rep. par. 6681; 6 P.H. 1966 Fed. Tax Serv. par. 54998), he has not complied with the requirements of section 482, and therefore should not be permitted to tax any of such income to any of the petitioners. We cannot agree. In such T.I.R. the respondent, by referring to certain proposed regulations, in effect took the position that any correlative adjustment need not be made until the correctness of his allocation under section 482 has been conceded or finally determined. While it is obvious that there should be a correlative adjustment to National's income, that company is not before us. The record does show, however, that National filed protective claims for refund.

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In view of the fact that we have sustained the respondent's allocation of 50 percent of net premiums to the finance companies, it necessarily follows, as agreed by the parties in the stipulation of facts, that a corresponding adjustment must be made in the taxable income of Guardian and Beneficial for the period January 1 to June 30, 1958, they having reported the commissions as their income. It also necessarily follows, as conceded by the respondent, that his alternative determination allocating 50 percent of net premiums to Guardian and Beneficial for the period July 1, 1958, to December 31, 1958, and for the taxable years 1959 through 1962 must be disapproved.

Reviewed by the Court.

Decisions will be entered under Rule 50.

FORRESTER, *J.*, concurs in the result.

TANNENWALD, *J.*, concurring: Petitioners herein would have us posit our decision on certain purportedly abiding principles which they claim prior cases have made into articles of faith, i.e., that a taxpayer may not be taxed on income which he cannot legally claim as his own, and that merely providing the source of income or the mere ability to designate who performs the income-producing services are insufficient touchstones of taxability. An examination of the decided cases, however, reveals that these so-called articles of faith represent no more than semantic rationalizations designed to sustain a result dictated by the particular factual situation involved. I would not, as the majority appears to have done, indulge in further propagation and thereby add to the confusion with which the decided cases already abound. I take my cue from the admonition of Mr.

Justice Holmes that "general propositions do not decide concrete cases" (see *Lochner* v. *New York*, 198 U.S. 45, 76 (1905) (dissenting opinion)) and would reach the majority result simply by answering these essentially factual questions:

(1) Did the approximately 8.4 percent of the payments received by National from Republic and not allocated by respondent to petitioners constitute adequate compensation for the reinsurance risk? I think it did. Petitioners offered no evidence to dispute the adequacy of the 8.4 percent in this regard. Indeed, the testimony of Arthur J. Cade, the former executive vice president of Republic, set forth in footnote 15 to the majority opinion, points to the likelihood that no reinsurance risk compensation whatsoever was intended. National had no claims or underwriting department or salaried employees except its attorney who acted as office manager and received $20 per month. I think it is clear therefore that the allocated payments in excess of 8.4 percent were commissions paid by Republic as compensation for services rendered with respect to credit life insurance business.

(2) Who performed the services which were thus compensated? Clearly, petitioners did. Their employees informed the customers of the availability of credit life insurance, prepared the papers relating to such insurance, handled refunds of premiums, completed the claim form in the event of death, and, after attaching a death certificate, forwarded the same to Guardian or Beneficial. Petitioners' employees received the premiums, segregated them, and deposited them in bank accounts in the branch office cities in the name of Guardian or Beneficial. Each week, petitioners' employees forwarded the insurer's copies of the register sheets, evidencing the issuance of the policies, to either Guardian or Beneficial for transmission to

Republic. Guardian and Beneficial were simply conduits for forwarding to Republic the papers prepared by petitioners; additionally, they prepared and sent to Republic a monthly report showing the amount of premiums collected, the amount of premiums refunded, and the net difference.

To be sure, at least one employee of each Indiana branch office of petitioners held a license as an Indiana life insurance agent for Republic. But, as far as the record reveals, this had no more than symbolic significance. Petitioners hired, controlled, and paid all the branch office employees involved in the handling of the credit life insurance; no part of the expenses relating to such employees or the services they performed was charged to Republic, National, Guardian, or Beneficial. Petitioners' argument that such services on the part of its employees were negligible is beside the point. It may well be that no significant services *on the part of anyone* were required in connection with the writing of credit life insurance activities. But, if such were the case, it would not follow that the income should remain with other parties, who did nothing, as against allocating such income to the petitioners, whose activities certainly produced the business.

The factual situation outlined is equally applicable to respondent's allocation to petitioners of 50 percent of the net premiums paid to Guardian and Beneficial during the period January 1 to June 30, 1958, except that the possibility of identifying such payments as compensation for the risk of reinsurance is concededly not involved.[1]

[1] The fact that respondent made no allocation from National to Guardian or Beneficial in respect of the post-1958 period is beside the point. It is entirely possible that respondent was overly generous in not allocating *all* of the 1958 payments to petitioners.

Under the foregoing circumstances, it cannot be gainsaid that petitioners performed the services for which the payments involved herein were made. Petitioners cannot avoid taxability on the allocated amounts simply because the payments were made to someone else. In none of the cases relied upon by petitioners, with one possible exception, did the taxpayer in fact perform the services for which the allocated payments were made. In each, as petitioners themselves point out on brief, the taxpayer was simply in "the position to have performed the services for which the income was paid but *chose not to do so.*" (Emphasis added.) At best, those cases stand for the proposition that the mere *possibility of performance* of services by the taxpayer does not sustain an allocation of payment by respondent. They do not hold that taxability cannot be imposed where the taxpayer *actually performs* the services. The possible exception is *Nichols Loan Corporation of Terre Haute,* T.C. Memo. 1962–149, reversed on other grounds 321 F. 2d 905 (C.A. 7, 1963). But it is significant that neither in the opinion of this Court nor that of the Court of Appeals was there any reference to section 482 and the opinion of this Court makes clear that its decision was based on a "consideration of all the evidence." In any event, if that case can be viewed as requiring a contrary result herein, I would not follow it.

Nor can petitioners take shelter from the application of section 482 simply because a violation of Indiana law was the genesis of the business purpose of the arrangements herein. I will assume, for the purposes of argument, that direct receipt of the commissions by petitioners would have violated Indiana law and also that the actual arrangements satisfied the requirements of that law, although the record herein

is not clear as to whether either of these conditions existed. Section 482 empowers respondent to allocate "in order clearly to reflect income." The presence of actual receipt of, or the legal right to receive or obtain, the allocated income is not always a necessary prerequisite to the application of that section. *L. E. Shunk Latex Products, Inc.*, 18 T.C. 940 (1952), does not hold otherwise. In that case, the taxpayer was caught in a vise imposed by the OPA regulations. The hard fact was that, by virtue of those regulations, it could not have charged any higher price to a wholly independent distributor than it did to the distributor which was under common control with it.[2] In short, the OPA regulations conclusively established an "arm's-length" price which the taxpayer actually charged its distributor. The taxpayer had no other choice except to forfeit the economic benefit, which respondent sought to tax, by selling its manufactured goods to an independent distributor. We were not disposed to impose such forfeiture and therefore held that, under such circumstances, section 482 could not properly be applied. In the instant case, the Indiana law left petitioners with a clear-cut alternative. The way was open to them to adopt arrangements under which National, Guardian, and Beneficial rather than petitioners themselves would, in fact, perform the services for which Republic made payment in the allocated amounts. Under such arrangements, petitioners could have continued to receive the same economic benefit.

It does not follow, as petitioners seem to assume, that, because they may have put sufficient flesh on the

[2] We carefully pointed out that there was no evidence that the taxpayer could have obtained an upward modification of the prices established by the OPA regulations.

bones of National, Guardian, and Beneficial to avoid problems under Indiana law, respondent is necessarily precluded from establishing different poundage requirements to support his a ocation under section 482. At the very least, petitioners, as they concede, had the burden of proving that respondent was arbitrary in so doing. In this respect, they have, in my opinion, failed to carry the day.

Since the respondent's action can be sustained under section 482, I see no purpose to be served by discussing the applicability of section 61. Indeed, I see good reason for not entering the mare's nest of the decided cases under that section. See Teschner, "Anticipation of Income," 41 Ind. L.J. 587 (1966); cf. Eustice, "Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case," 20 Tax L. Rev. 1 (1964).

DAWSON, *J.*, agrees with this concurring opinion.

DRENNEN, *J.*, dissenting: I am not sure that I would agree with the majority, as Judge Fay has done, that National was a viable business entity and not a sham. But if National's vitality is assumed, I agree with Judge Fay that the taxation of the major portion of the reinsurance income to the petitioners here is contrary to the previously decided cases cited in his opinion and is also difficult to make coexist with *L. E. Shunk Latex Products, Inc.*, 18 T.C. 940.

I wish to add that I disagree with the approach taken by the concurring opinion of Judge Tannenwold wherein he concludes that the 8.4 percent of the payments received by National from Republic and not allocated by respondent to petitioners constituted adequate compensation for the reinsurance risk, and the balance represented commissions paid by Republic as compensation for services rendered with respect to

the credit life insurance business. I do not believe it is the business of this Court to determine what is a reasonable fee for reinsuring this type of risk. That would be a matter for the State insurance commission to decide. If the fee allowed was higher than the risk warranted, in order to pay commissions, then those commissions would be payable by National not Republic. If the premiums chargeable and charged for this type insurance were more than adequate to cover the cost of writing it and the risk involved, I do not believe either the Commissioner or this Court should attempt to allocate the excess to the cost of performing the services of writing the insurance rather than to the risk involved, which National assumed.

FAY, *J.*, dissenting: With all deference, I am unable to agree with the conclusion reached by the majority of the Court. It is my opinion that the rationale relied upon by the majority is contrary to existing case law and an unwarranted application of the statute.

The majority finds as a fact that National, the reinsurer, was a bona fide insurance company. It holds that National assumed liability for the reinsurance of the policies written by Republic and that it could validly retain part of the total premium. We agree with the majority that National was a viable business entity and not a sham.

The majority holds that a portion of the commission income received by Guardian and Beneficial during the period January 1 to June 30, 1958, and a portion of the reinsurance premiums received by National during the period July 1, 1958, to December 31, 1962, constituted compensation earned by the finance companies for selling and processing the credit life in-

surance. It further holds that petitioners exercised the power to dispose of such income by diverting it first to Guardian and Beneficial and later to National, rather than receiving it themselves. It concludes that, under section 61, this income is properly taxable to petitioners despite the actual receipt by others.

The majority relies principally upon the services performed by the petitioners in connection with the sale and servicing of the insurance. It lists the following facts as being descriptive of these services: Petitioners wrote the policies, collected premiums, deposited them in bank accounts in the names of Guardian and Beneficial, made refunds, prepared the necessary papers in the event of the death of the insured, and made weekly reports to Guardian and Beneficial. For the years 1958 through 1962, the cost to the petitioners of the services was approximately $60,000. Guardian and Beneficial prepared monthly reports of the collated information and forwarded these reports together with the net premiums to Republic. The cost of this processing service to Guardian and Beneficial for the period July 1, 1958, through December 31, 1962, was approximately $11,000.

Though petitioners' activities in filing death claims were consistent with their status as beneficiaries under the policies, it is true that they have, along with Guardian and Beneficial, performed some services in connection with the sale and servicing of these policies. I do not agree, however, that these activities can result in the allocation urged by the respondent.

I think the case at bar is controlled by such cases as *Nichols Loan Corporation of Terre Haute*, T.C. Memo. 1962–149, reversed on other grounds 321 F. 2d 905 (C.A. 7, 1963); and *Campbell County State Bank, Inc.*, 37 T.C. 430 (1961), reversed and remanded on another issue 311 F. 2d 374 (C.A. 8, 1963). See also

Jaeger Motor Car Co. v. *Commissioner,* 284 F. 2d 127 (C.A. 7, 1960), affirming a Memorandum Opinion of this Court, certiorari denied 365 U.S. 860 (1961), *Moke Epstein, Inc.,* 29 T.C. 1005 (1958); and *Ray Waits Motors* v. *United States,* 145 F. Supp. 269 (E.D.S.C. 1956).

In both *Nichols* and *Campbell,* the employees of several loan corporations and of a bank provided services similar to those provided by the petitioners herein in selling and servicing insurance policies. No compensation was received by them for so doing. In the *Nichols* case the total payments went to one of the loan corporations' shareholders and was divided by him with the other shareholders. In *Campbell* the payments went to a partnership formed by the bank shareholders. In both cases none of the shareholders actually performed any services nor did they compensate the lending institutions for any space or materials or expenses of the solicitation or processing service. I am aware that in the *Campbell* case the partnership ostensibly "hired" three employees but we found therein that they were persons who were already bank employees and who were treated as having been compensated wholly by the bank for withholding purposes. In both these cases we held that none of the income of the individual shareholders in *Nichols* or the partnership in *Campbell* was taxable to the loan corporations or to the bank, respectively. This Court in the *Campbell* case rejected respondent's position that the partnership was a sham and held that the bank did not earn the income and in the *Nichols* case rejected respondent's general argument that the income was chargeable to the loan companies. In this connection, I would point out that the Court of Appeals for the Seventh Circuit in reversing on another issue in *Nichols* held that the expenses of the loan

companies were so minimal regarding the insurance operation as not to require any reallocation of the companies' expense deductions. In this light it appears strange that the majority now uses the same type of activity on the part of the finance companies as a basis to allocate to them 50 percent of the net premiums.

I can find no meaningful distinction between the actual services in these two cases and the case at bar. Therefore, I am of the opinion that to hold, as the majority does here, in the absence of a finding that the reinsurer, National, was a sham, that the income is not properly taxable to a corporation set up by a majority of the finance companies' shareholders is irreconcilable with our earlier holdings that the same type of income is properly taxable directly to the loan corporations' shareholders (*Nichols*) or to a partnership made up of bank shareholders (*Campbell*). I cannot conceive that the fact that in *Nichols* and *Campbell* what is essentially the profit in the credit insurance operation was passed ultimately to shareholders of the loan companies or bank in the form of a commission operates to distinguish it from this case where the profit vehicle takes the form of a reinsurance premium.

Even assuming *arguendo* as the majority concludes that some part of the income is taxable to those who perform the services, I cannot understand how it allocates all of the income to the finance companies thereby ignoring the fact that services were also performed by Guardian and Beneficial. I am of the opinion that such a conclusion is not consistent with the rationale upon which it is based.

The majority opinion also relies upon section 482 for support in allocating the income to petitioners in order to clearly reflect income. The premise of this

approach is the previously reached conclusion that petitioners have earned the income by the performance of various services and have exercised a power of disposition over this income to channel it to the reinsurance company. The majority would negate the application of the *Nichols* and *Campbell* cases by noting that therein the loan companies and the bank did not "earn" the income. I cannot agree. The same criteria used by the majority to conclude that the petitioners herein earned the income were present in both the earlier cases. In neither of these earlier cases were services performed by the stockholders who actually received the money. Indeed, it would appear that the case before us contains stronger facts in this regard than either *Nichols* or *Campbell* since National seems possessed of a more readily apparent business operation in connection with the profit from the insurance, i.e., reinsuring the risk, than was possessed by either of the stockholder groups in the earlier cases which did no more than receive the income. I again am of the opinion that the majority's rationale is not reconcilable with our earlier decisions in this area.

Unable to distinguish this case from our earlier decisions, I am left with the curious result that where employees of lending institutions perform services regarding credit life insurance the stockholders of those institutions may validly take a profit from the insurance business by setting up a partnership to receive it but may not validly take, in effect, the same profit by setting up a legitimate insurance company to reinsure the risk.

I am aware of the favorable tax treatment which may be available in some circumstance to insurance companies. Because of this treatment, favorable tax consequences might inure to the petitioners if the Court were to follow *Nichols* and *Campbell* in the

case at bar. I do not, however, think that the case law permits us to prevent this result. I do not contend that section 482 is inapplicable to insurance companies. I do contend that, as interpreted by existing case law, it does not apply to these facts. If favorable tax treatment is to be prevented in such cases as this, it is in my opinion up to Congress to do so. See the excellent discussion of the boundary between legislative and judicial jurisdiction in this area in *Alinco Life Insurance Co.* v. *United States,* 373 F. 2d 336 (Ct. Cl. 1967), which held that section 269 did not authorize the Commissioner to disallow the benefits of the special tax treatment of life insurance companies to a reinsurer controlled by the lending institution. It is particularly noteworthy in this context to consider the past history of respondent's attempts to attack various business-connected insurance arrangements. Respondent has pitched his arguments on sections 61, 269, 482, and a general argument that income was properly taxable to a lending institution rather than a controlled reinsurer or the shareholders of the lending institution as partners of an insurance agency. All these approaches have been repeatedly rejected by this and other Courts. See cases cited, *supra.* The only case in which a court has held that this type of arrangement gives rise to income, taxable to the lending institution, is *Bank of Kimball* v. *United States,* 200 F. Supp. 638 (D.S.Dak. 1962), in which the District Court held, because no valid partnership had been formed, that commissions were taxable to the bank rather than to the alleged partnership comprised of its stockholders. The court, however, noted that for later years, after a formal partnership agreemen thad been signed by the stockholders, the Government had conceded that the income thereafter was properly taxable to it and not to the bank.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

Local Finance Corporation
Local Finance Corporation of South Marion
Local Finance Corporation of Elkhart
Local Finance Corporation of Gas City
Local Finance Corporation of Rushville
Local Finance Corporation of Danville
Local Finance, Inc.
Local Finance Co., Inc., of Gary
Local Finance Company, Inc.,

Petitioners

v.

Commissioner of Internal Revenue

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

and

RESPONSE TO THE COMMISSIONER'S PROTECTIVE PETITION FOR WRIT OF CERTIORARI

in

Commissioner of Internal Revenue,

Petitioner,

v.

Guardian Agency, Inc. and
Beneficial Insurance Agency, Inc.

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IN THE

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NO.

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Petitioners

v.

Commissioner of Internal Revenue

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgments of the Court of Appeals for the Seventh Circuit affirming decisions of the Tax Court of the United States upholding income tax deficiencies in the aggregate sum of $418,977.31 determined by the Commissioner of Internal Revenue for the calendar years 1958 through 1962.

OPINIONS BELOW

The opinions of the Court of Appeals and of the Tax Court are reported at 407 F.2d 629 and 48 T.C. 773. They are printed as Appendix A and Appendix C, respectively, of the Commissioner's protective petition for writ of certiorari in the related cases involving Guardian Agency, Inc. and Beneficial Insurance Agency, Inc. Appendix references in this petition are to those Appendices, unless otherwise indicated.

JURISDICTION

The judgments of the Court of Appeals were dated and entered on February 28, 1969. A petition for rehearing was denied on April 9, 1969. As a result of orders signed by Mr. Justice Marshall on June 27 and August 1, 1969, the time within which to petition for certiorari was extended to and including September 6, 1969.

This Court has jurisdiction to review the judgments of the Court of Appeals for the Seventh Circuit by writ of certiorari under Section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 7482 (a)) and 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether, because the petitioning loan companies handled the clerical details involved in selling and servicing credit life insurance on their borrowers and were in a position to select the insurance carrier, they can be taxed (under Sections 61 or 482 of the Internal Revenue Code) on (1) commissions paid by the carrier to related insurance agencies or (2) premiums paid by the carrier to a related life insurance company to reinsure the risks, where the loan companies were prohibited by state law from deriving any income from credit life insurance.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.)

§ 61. GROSS INCOME DEFINED.

(a) *General Definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * *

§ 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Treasury Regulations on Income Tax

§ 1.482-1. DETERMINATION OF THE TAXABLE INCOME OF A CONTROLLED TAXPAYER. (26 CFR § 1.482-1, added by T.D. 6595, April 13, 1962, 1962-1 Cum. Bull. 49.)

(a) *Definitions.* When used in this section—

* * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or,

as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * *

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to spe-

cial scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

STATEMENT

The Undisputed Facts

The basic facts, which are undisputed, are taken from the Tax Court's findings of fact. (App. C, pp. 22 et seq.)

Petitioners, Local Finance Corporation and eight wholly owned subsidiaries, are engaged in the small loan business in Indiana.

Since 1936, the loan companies have made available to their customers credit life insurance, which pays off the debt in case the borrower dies during the term of the loan. When a customer elected to take coverage, the necessary insurance paper work was done by the loan company's employees simultaneously with the preparation of the loan papers. Weekly lists of insurance policies issued and premiums received from customers were sent to Guardian Agency, Inc. and Beneficial Insurance Agency, Inc., whose stock was owned by persons who owned over 70% of the stock of the loan companies. The insurance agencies, in turn, submitted monthly reports and premiums to an inde-

pendent life insurance underwriter (Old Republic Life Insurance Company).

The annual cost of servicing credit life insurance was about $12,000 to the loan companies and about $2,200 to the insurance agencies.

Borrowers paid the going premium for credit life insurance in Indiana ($1 per $100 of insurance), a rate which was sufficient to allow insurance underwriters to pay acquisition costs. However, the Indiana Small Loan Act prohibited loan companies from receiving anything other than the charges permitted by the statute. In order to avoid penalties for violating the Small Loan Act (which included fines and imprisonment, forfeiture of the right to collect both principal and interest, and revocation of small loan license), the loan companies consistently refused to accept any compensation for handling credit life insurance. Nevertheless, the loan companies benefited from offering credit life insurance: it constituted an added attraction to customers (which competitors were also offering), provided for repayment of insured loans in case of death, and improved public relations by eliminating demands for payment upon the families of deceased borrowers.

Prior to July 1, 1958, insurance commissions were, for a period of time, paid by Old Republic directly to the insurance agencies. Later, commissions were paid to the insurance agencies indirectly through Donald Miller, an officer of the insurance agencies, as well as of the loan companies. Miller was Old Republic's agent, but endorsed his commission checks over to the insurance agencies.[1] This ar-

1. The Commissioner's protective petition for writ of certiorari in the *Guardian* and *Beneficial* cases erroneously states (p. 3) that the independent insurance carrier at first "paid Local Finance" a commission and that, subsequently, "Local Finance assigned the Commission income to Guardian." (See App. A, pp. 9-10; App. C, pp. 25-29.)

rangement was designed to comply with Indiana insurance law, which prohibited the payment of life insurance commissions to corporate insurance agents. Subsequently, the Indiana insurance department ruled that such indirect commission payments were equally in violation of the insurance law and Old Republic became concerned over the possibility of losing its Indiana license. Consequently, an entirely new arrangement was instituted as of July 1, 1958.

A life insurance company (Grand National Life Insurance Company) was formed and persons who owned 98% of Guardian's stock subscribed for 99% of Grand National's stock. Grand National entered into a reinsurance treaty with Old Republic and assumed all of the insurance risk in return for 90.5% of the premiums paid to Old Republic by the loan companies' borrowers. Neither Old Republic nor Grand National paid any commissions on this insurance.

The Commissioner of Internal Revenue attributed to the loan companies additional income, in the form of insurance commissions, equal to 50% of the premiums collected during 1958 through 1962. For the period January 1 through June 30, 1958, the amounts allocated to the loan companies were out of commission income which had been received and reported for tax purposes by the insurance agencies, Guardian and Beneficial. For the remaining period (July 1, 1958 through December 31, 1962), the allocation was of income which had been received as insurance premiums by Grand National and reported by it for tax purposes.[2]

---

2. Alternatively, the Commissioner allocated 50% of premiums for this period to the insurance agencies. It is this alternative allocation which is involved in the Commissioner's protective petition for certiorari.

The Tax Court Opinions

A divided Tax Court upheld the Commissioner's allocation of income to the loan companies and denied his alternative allocation to the insurance agencies.

The majority opinion found that Grand National "was a bona fide insurance company, that it did assume liability for reinsurance of the policies written by [Old] Republic, and that it was entitled to compensation for assuming such reinsurance risk." (App. C, p. 50.) Nevertheless, the majority concluded that it was the loan companies that "performed all the services in connection with the sale and servicing of the insurance," that it was they who "earned, and controlled the disposition of, the commission income," and that they had exercised "their power to dispose of such income by having Miller assign it to Guardian and Beneficial" and, after July 1, 1958, by having it paid by Old Republic to Grand National as reinsurance premiums. (App. C, pp. 46-48.) This, it was held, constituted a basis for taxing to the finance companies income which they had not received—and could not lawfully receive. In so holding, the majority relied principally on Section 61 of the Code, as they conceived it to have been interpreted by this Court in such cases as *Lucas* v. *Earl,* 281 U.S. 111 (1930) and *Helvering* v. *Horst,* 311 U.S. 112 (1940). They apparently considered Section 482 to be only a vehicle for the application of the general principles evolved in the Section 61 cases to situations involving commonly controlled business entities. (App. C, p. 46.)

Judge Tannenwald (Judge Dawson, agreeing) concurred with the majority result on the ground that the finance companies had performed selling and servicing functions for which they had not been compensated. He saw no purpose in "entering the mare's nest of the decided cases"

under Section 61 and placed his reliance solely on the broad discretion granted to the Commissioner in Section 482. (App. C, p. 63.)

Chief Judge Drennen dissented on the ground that the majority decision could not be squared with precedent. (App. C, p. 63.)

Judge Fay also dissented (App. C, p. 64) because: (1) the majority opinion is contrary to existing case law and an unwarranted application of the statute, (2) the minimal services performed by the loan companies, costing about $60,000 during the five years involved, did not justify the Commissioner's allocation (over $600,000 of income), and (3) the majority was really attempting to vitiate the effect of the partial tax deferral granted by the Internal Revenue Code to life insurance companies—a matter for legislative, not judicial, concern. He pointed out that, despite repeated attacks by the Commissioner, this is the first time a court has taxed a lending institution on income from the sale of insurance to its customers where some other bona fide entity had in fact received the income and the lending institution was prohibited by law from receiving it.

The Court of Appeals Opinion

The Seventh Circuit affirmed the Tax Court, relying heavily on the broad discretionary power to allocate income among related entities granted to the Commissioner in Section 482.

The court held that allocation of income under Section 482 turns on who actually earned the income and that the Commissioner's allocation merely compensated the loan companies for the selling and processing services performed by their employees, which, however minimal, were the *sine qua non* of the credit insurance business.

The court rejected the argument that the loan companies cannot be taxed on income they did not—and could not lawfully—receive. In reaching that conclusion, it held that "the criteria of what constitutes income under Section 61 and the appropriateness of an allocation under Section 482 are matters of federal law" (citing *Burnet* v. *Harmel*, 287 U.S. 103 (1932). The federal law relied on by the court consisted of two lines of cases which have held that, under certain circumstances, income may be taxed to one who did not actually receive it (e.g., *Lucas* v. *Earl*, 281 U.S. 111 (1930)) and that one may be taxed on income actually—though unlawfully—received (e.g., *James* v. *United States*, 366 U.S. 213 (1961). (App. A, pp. 14-15.)

REASONS FOR GRANTING THE WRIT

I. The Courts Below Have Misinterpreted and Misapplied This Court's Section 61 Decisions

While the courts below appear to rely primarily on the Commissioner's broad discretionary power to allocate income under Section 482 of the Code, it is apparent that they determined the propriety of the exercise of that power in light of this Court's decisions that income may sometimes be taxed to one who does not actually receive it—the so-called Section 61 assignment of income cases. In so doing, they failed to grasp the rationale of those decisions and ignored the carefully articulated limitation on the doctrine, *viz.*, that the taxpayer must have the legal right to take the income for himself.

Lucas v. *Earl*, 281 U.S. 111 (1930), does indeed hold that the burden of taxation cannot be shifted by a breadwinner to his wife through an anticipatory assignment of his income. But in *Poe* v. *Seaborn*, 282 U.S. 101, 117 (1930), the Court distinguished *Earl* and upheld the right of a wife to file a separate return, treating one-half of the husband's earnings as her separate property under Washington community property law:

> "The very assignment in that case [*Earl*] was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which it could operate. That case presents quite a different question from this, because here, by law, the earnings are never the property of the husband, but that of the community."

Thus, the Court specifically recognized the taxpayer's inability to take the income for himself because of a state-imposed, rather than a self-created, disability.

The assignment of income cases decided after *Earl* have consistently held that it is the taxpayer's ability to take the income for himself that justifies taxing him. In *Corliss* v. *Bowers,* 281 U.S. 376, 378 (1930), a husband was taxed on the income of a revocable trust established for his wife, but only because—

> "**** income that is subject to a man's *unfettered command* and that he is *free to enjoy* at his *own option* may be taxed to him as his income, whether he sees fit to enjoy it or not." (Emphasis supplied.)

In *Helvering* v. *Horst,* 311 U.S. 112, 119 (1940), a father was taxed on bond interest represented by a coupon clipped and given to his son prior to its maturity because he was "*entitled to receive it*" and had exercised his "power to dispose of it in procuring satisfaction which he would otherwise procure only by the use of the money when received." (Emphasis supplied.)

And in *Harrison* v. *Schaffner,* 312 U.S. 579, 582 (1941), a mother was taxed on future trust income which she, as beneficiary, had assigned to her children because she was "vested with the right to receive income" and, by exercising her command over the income, enjoyed its benefit.

No decision of this Court deviates from the concept that it is the exercise of the taxpayer's option *either* to take the income for himself *or* to divert it to another that justifies the imposition of the tax. This Court has yet to hold that someone can be taxed on income which he did not receive and which he could never become entitled to receive.

Moreover, until the decisions of the courts below in this case, the lower courts have recognized the importance of legal impediments to the receipt of income and have refused to attribute income to taxpayers who "did not receive and [were] not entitled to receive" it. *Bear Valley*

Mutual Water Co. v. *Riddell,* 283 F. Supp. 949, 955 (C. D. Calif. 1968). In *Teschner* v. *Commissioner,* 38 T.C. 1003 (1962), the Tax Court itself refused to tax a father who, disqualified by contest rules from receiving a prize, submitted a winning entry in his daughter's name:

> "Where an individual neither receives nor has the right to receive income, he is not the taxable individual within the contemplation of the statute. There is no basis in the statute or in the decided cases for a construction at variance with this fundamental rule." 38 T.C. at 1009.

The Tax Court flatly rejected the Commissioner's broad contention—now approved in the decisions below—that the touchstone of taxation is whether the taxpayer earned or generated the income through his own efforts. The court recognized that this was not enough. The taxpayer must, in addition, *either* have received the income *or* have had the right to do so. 38 T.C. at 1007.

Like the community property law in *Poe* v. *Seaborn,* 282 U.S. 101 (1930), and the contest rules in *Teschner,* Indiana law precluded the loan companies from becoming entitled to receive the income attributed to them by the Commissioner. This function of state law in no way conflicts with the supremacy of federal tax law, as the courts below assumed. There is no attempt here to superimpose state property classifications on federal tax laws, as there was in *Burnet* v. *Harmel,* 287 U.S. 103 (1932). Rather, this is a case where state law has determined that the taxpayer can have no "legal interests and rights" upon which federal tax law may operate. *Morgan* v. *Commissioner,* 309 U.S. 78, 80-81 (1940). Nor is there any attempt here to derogate from this Court's holding that *actual*—though unlawful—receipt of income, by an embezzler for example, is a basis for taxation. *James* v. *United States,* 366 U.S. 213 (1961).

One who, like these petitioners, has never had either possession or the right to possess income does not have the necessary "command" over income to justify taxation. He is not "free to enjoy at his own option" income the receipt of which would entail a violation of state law. To hold otherwise would result in the total disregard of petitioners' attempts to structure their business affairs in compliance with state law. In addition, it would virtually force taxpayers to violate state law and take the income attributed to them for tax purposes in order to pay the tax on such income. Cf. *Eisner* v. *Macomber,* 252 U.S. 189, 213 (1920).

II. The Use of Section 482 to Allocate Income Which Cannot Lawfully be Received Raises an Important Question of Federal Tax Law

Section 482 authorizes the Commissioner to allocate income and deductions among commonly controlled business entities if he determines that such allocation is necessary in order to prevent "evasion of taxes or clearly to reflect the income" of any of such entities. This provision, which first appeared in its present form in the Revenue Act of 1928, was designed—

> "*** to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., p. 16 (1939-1 Pt. 2 Cum. Bull. 395).

The test for determining whether an allocation is warranted under Section 482 is whether—

> "*** the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Reg. § 1.482-1 (c), *supra,* p. 5.

The way in which the credit insurance business was handled in this case (payment of commissions to the insurance agencies prior to July 1, 1958 and reinsurance with Grand National thereafter) did not result in any "milking" of the loan companies or "shifting of profits" from them to related entities because the loan companies could not lawfully take any profit from the credit insurance business and there is no basis for assuming that, absent the commission and reinsurance arrangements, they would have taken income in violation of state law. Contrary to the Court of Appeal's assumption (App. A, p. 16), the Tax Court made no finding that, had it not been for Grand National, commissions would have been paid to Local Finance. Applying the test propounded by the Regulation, the taxable income of the loan companies would not have been any greater even if the insurance agencies and Grand National were not related entities and the loan companies had dealt with them at arm's length.

It may well be that, if the insurance agencies and Grand National had not been related parties, the commission and reinsurance arrangements would never have been made. But this does not justify an attribution to the loan companies of income which they could not have lawfully received in any event. The Court of Appeals clearly misunderstood the purpose of the arm's length test when it said—

> "the Commissioner is empowered *** to determine whether [transactions between commonly controlled entities] are such as would have been consummated in an arm's length negotiation between strangers and to make an allocation when they fail to meet that standard." (App. A, p. 11.)

The question is not whether the transactions are the same as would have been entered into between strangers, but whether the income of the controlled entity to which the

income is allocated would have been any different if it had been dealing at arm's length with a stranger. Only then is the Commissioner authorized to reallocate income. Here, there is no basis for assuming that the loan companies would have received any income from credit life insurance regardless of how or with whom the mechanics might have been handled.

Likewise, the courts below misunderstood the import of the only precedent involving the application of Section 482 where the taxpayer is precluded by law from receiving the income sought to be allocated. *L. E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T.C. 940 (1952), involved the classic economic situation which Section 482 was designed to prevent: the price for rubber prophylactics charged by the manufacturer to its commonly controlled wholesaler was lower than current market conditions warranted. The price had been established in 1937 and never changed in a sharply rising market. The manufacturer's failure to increase prices shifted profits to its related wholesaler, which took advantage of the rising market to increase its prices to retailers. Nevertheless, the Tax Court refused to allow the Commissioner to allocate income to the manufacturer because the applicable OPA regulation had frozen the manufacturer's price as of December 1, 1941 and it could not have lawfully charged more—whether to its own wholesaler or to an independent wholesaler.

The Court of Appeals sought to distinguish *Shunk* on the ground that—

> "The OPA regulations in *Shunk* prevented the *generation* of the income which the Commissioner sought to allocate; here Indiana law merely prohibited the *receipt* of the commission income by the finance companies." (App. A, pp. 17-18; emphasis supplied.)

But no such distinction is tenable. The income which the Commissioner sought to allocate was the income generated by the wholesaler's ability to purchase from its affiliated manufacturer at less than market. The Tax Court refused to tax that income to the manufacturer only because the OPA regulations had the effect of—

> "* * * prohibiting petitioners from *receiving* the very income sought to be attributed to them. We think that the Commissioner had no authority to attribute to petitioners income which they could not have *received.*" (18 T.C. at 961; emphasis supplied.)

In truth, there is no substantive difference between the situation in *Shunk* and the situation we have in this case. By disregarding the OPA ceiling the manufacturer in *Shunk* could have charged more for its product. Likewise, the loan companies here might have commanded compensation for selling and servicing credit life insurance had they been willing to violate state law. In both instances, however, legal prohibitions deprived the taxpayers of the option to realize the economic benefit otherwise available to them. The intervention of the OPA regulation in *Shunk* and the Indiana Small Loan Act here broke the causal relationship between the common control of the related entities and what otherwise would have been the most natural economic consequences. Hence, there is nothing on which Section 482 can operate.

This court has never had occasion to consider and interpret Section 482—perhaps because, although Section 482 and its predecessors have been a part of the income tax law for over 40 years, the Commissioner has only rather recently begun to use the provision vigorously. See Spaeth, *Section 482—Past and Future,* 47 Taxes 45 (1969); Seieroe and Gerber, *Section 482—Still Growing at the Age*

of 50, 46 Taxes 893 (1968) (discussing and criticizing the novel result in this case); Asbill, Jr., *The Application of Section 482 to Domestic Taxpayers—Current Status and Trends,* 19 So. Calif. Tax Institute 673, 673-674, 729 (1967); Comment, *New Importance for Section 482 of the Internal Revenue Code,* 7 W & M L. Rev. 345 (1966).

It has been held that, under Section 482, the Commissioner's determination that an allocation is necessary is subject to review only if it is unreasonable, arbitrary, or capricious. *Grenada Industries, Inc.* v. *Commissioner,* 17 T.C. 231 (1951), *aff'd,* 202 F.2d 873 (5th Cir. 1953), *cert. denied,* 346 U.S. 819 (1953). The taxpayer's burden of proof under this standard is significantly greater than under the ordinary standard, where proof of mere error is sufficient. If, as the Tax Court majority says (App. C, p. 46), Section 482 is merely a specific vehicle for applying Section 61 principles in situations involving commonly controlled business entities, Section 482 is surplusage. Moreover, there could develop a curious and irrational dichotomy between the functions of Section 61 and Section 482: where family income-splitting arrangements are involved, the taxpayer's burden would be lighter than where arrangements between commonly controlled business entities are involved. There is, therefore, urgent need for this Court to provide guidance to the Commissioner and the courts on the relationship between Sections 61 and 482 while the Commissioner's use of his new-found power is still in the development stage. As interpreted and applied by the two courts below, Section 482 confers upon the Commissioner protean power to restructure business transactions involving related business entities—a power that transcends the limitations imposed by this Court in the Section 61 cases.

The importance of this Court's reviewing the use of Section 482 to allocate income which cannot be lawfully re-

ceived is illustrated by the fact that, in addition to these cases, there are 1,399 cases pending in the lower courts involving the allocation of $232,470,659 of income from insurance companies to related loan companies, insurance agencies, or their stockholders. Pertinent information concerning those cases, many of which involve alternative allocations of the same income, is contained in the Appendix to this petition.

III. The Result Reached by the Courts Below Conflicts With the Treatment Accorded Comparable Arrangements in Other Cases

Over the years, corporations such as banks, finance companies, and automobile dealers, precluded by state law from receiving compensation from the sale of insurance to their customers, have devised different methods of handling their affairs so as to allow related parties to profit where they themselves could not. Using as his pivotal argument the fact that employees of these businesses sold the insurance and handled the necessary paper work, the Commissioner has tried every weapon in his arsenal to restructure these transactions. Until the decisions in this case, the lower courts have rebuffed the Commissioner at every turn, recognizing the problem posed by state law and the right of taxpayers to structure their business affairs as they choose,[3] regardless of tax savings.[4]

The most common arrangement was for the individual owner of the corporation to take out an insurance agency license and receive insurance commissions personally. The courts readily accepted such arrangements where the pres-

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3. *Moline Properties, Inc.* v. *Commissioner,* 319 U.S. 436 (1943); *National Carbide Corp.* v. *Commissioner,* 336 U.S. 422 (1949).

4. *Gregory* v. *Helvering,* 293 U.S. 465 (1935).

idents and principal shareholders of family automobile businesses acted as casualty insurance agents—even though the actual work may have been done by the employees of the corporation without additional compensation. *Ray Waits Motors, Inc.* v. *United States,* 145 F. Supp. 269 (E.D. S.Car. 1956); *Moke Epstein, Inc.* v. *Commissioner,* 29 T.C. 1005 (1958); *Gaddy Motor Company, Inc.* v. *Commissioner,* T.C. Memo. 1958—189 (17 T.C.M. 944); *Jaeger Motor Car Co.* v. *Commissioner,* T.C. Memo. 1958—223 (17 T.C.M. 1098), *aff'd,* 284 F.2d 127 (7th Cir. 1960), *cert. denied,* 365 U.S. 860 (1961).

Similarly, in the field of credit life insurance such individual or partnership insurance agencies have been upheld and no attribution of commission income to the related financial institutions has been permitted, despite various arguments that, under Section 61 of the Code, the insurance agencies should be disregarded as a "sham," that the income was really earned by the corporation whose employees sold and serviced the insurance, and that Section 482 authorized a reallocation of income. *Campbell County State Bank, Inc.* v. *Commissioner,* 37 T.C. 430 (1961), *rev'd on other grounds,* 311 F.2d 374 (8th Cir. 1963); *Paramount Finance Co.* v. *United States,* 304 F.2d 460 (Ct. Cl. 1962); *Bank of Kimball* v. *United States,* 200 F. Supp. 638 (S.D. 1962); *Nichols Loan Corp.* v. *Commissioner,* T.C. Memo. 1962—149 (21 T.C.M. 805), *rev'd on other grounds,* 321 F.2d 905 (7th Cir. 1963);[5] *First Security Bank* v. *United States,* 213 F. Supp. 362 (Mont. 1963), *aff'd,* 334 F.2d 120 (9th Cir. 1964); *First State Bank* v. *United States,* (D.C. S.D., decided June 25, 1962; unofficially reported at 62-2 U.S.T.C. ¶ 9613).

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5. The court, in *Nichols,* also refused to disallow to the finance company, as an ordinary and necessary business expense deduction, the cost of selling and servicing the insurance program because the cost was minimal and the insurance program was beneficial to the loan business.

Another technique, developed subsequently, was to eliminate the insurance agency "middle man" and form a separate insurance company to arrange with the unrelated insurance carrier for reinsurance of the mortality risk. Although this meant giving up guaranteed commissions, there was a possibility of a greater profit through the assumption of an underwriting risk. Moreover, because of the fact that much of the premiums must be set aside to fund the risk, insurance companies are taxed differently—often more advantageously—than ordinary corporations. In *Alinco Life Insurance Company* v. *United States,* 373 F.2d 336 (Ct. Cl. 1967), the Commissioner attacked this arrangement, contending that, under Section 269, the reinsurance company was not entitled to be taxed as a life insurance company under Section 801 *et seq.* of the Code because it had been formed primarily to avoid taxes by securing the benefit of life insurance status. The Court of Claims, however, held that it was not tax avoidance to structure business affairs in response to the requirements of state law and that there could be no objection to arranging one's affairs to take advantage of the treatment afforded to life insurers by the Code.

The courts below have swept aside all of these precedents in order to tax the loan companies on insurance commissions received by Guardian and Beneficial and reinsurance premiums received by Grand National, by cross-fertilizing misinterpretations of the anticipatory assignment of income doctrine under Section 61 and the purpose of allocations of income under Section 482.

IV. The Heart of the Matter: The Exercise of Reciprocity Power Is Not Subject to Income Taxation

The heart of the matter is that while the loan companies could not take any compensation from credit life insurance,

they were in a position to arrange for a related corporation (owned by persons who owned about 70% of the stock of the loan companies) to perform a function for which the unrelated insurance carrier was willing and *able* to pay compensation—at first, for acting as insurance agent and placing the business with the unrelated insurance company and, later, for reinsuring the risks of the unrelated insurance company. The power to place another person (even though closely related) in a position to perform such a function has never before been considered the touchstone of taxability—even though the effort required to perform the function is minimal in relationship to the compensation paid.[6] *Crowley* v. *Commissioner*, 34 T.C. 333 (1960); *Alabama-Georgia Syrup Co.* v. *Commissioner*, 36 T.C. 747 (1961) *rev'd on other grounds, sub. nom. Whitfield* v. *Commissioner*, 311 F.2d 640 (5th Cir. 1962); *Nat Harrison Associates, Inc.* v. *Commissioner*, 42 T.C. 601 (1964).

CONCLUSION

This case follows in the tradition of the cases in which this Court has evolved the role and defined the limits of Section 61: cases involving assignments of income, family income-splitting, transactions lacking business purpose, substance versus form, family partnerships, family trusts, and illegal income actually received. It draws together, for consideration in a business reciprocity context, some of the most difficult and fundamental issues in federal tax law: what are the economic and legal bases for taxing income to someone other than the recipient under Section 61?; what

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6. What reason is there for assuming, for example, that the insurance risk undertaken by Grand National is less significant than the paper work done by employees of the loan companies?

is the extent of the Commissioner's power under Section 482 to restructure bona fide business transactions undertaken in compliance with state law?; what are the limitations on the right of taxpayers to structure their business transactions in the most advantageous way for tax purposes?; and what is the relationship between Section 61 and Section 482? These questions go to the very heart of income tax theory concerning what is taxable income and to whom it shall be taxed. This court should exercise its power of review to correct the lower courts' misinterpretation of the role of state law in the resolution of these questions.[7]

Respectfully submitted,

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7. If certiorari is granted, petitioners agree that the Court should also grant the Commissioner's protective petition for certiorari in the *Guardian* and *Beneficial* cases, so that the Court will have before it for consideration both of the Commissioner's alternative theories of income attribution—primarily from the insurance agencies and the reinsurance company to the loan companies and secondarily from the reinsurance company to the insurance agencies.

APPENDIX

TABLE OF PENDING CASES INVOLVING ALLOCATION OF INCOME FROM INSURANCE COMPANIES TO RELATED LOAN COMPANIES, INSURANCE AGENCIES, OR STOCKHOLDERS

Cases Pending in the Tax Court:

Docket No.	Amount Allocated	Docket No.	Amount Allocated
1190-63	$ 361,276	1664-65	$ 154,239
1216-63	405,220	1665-65	9,269
1294-63	36,639,159	1666-65	23,621
4680-64	1,056,047	1667-65	1,145
4681-64	291,417	1668-65	6,823
4682-64	221,315	1669-65	3,327
4683-64	32,347	1670-65	35,252
4684-64	101,358	1671-65	180,013
4685-64	74,118	1672-65	19,395
4686-64	43,840	1673-65	8,203
1649-65	135,042	1674-65	5,723
1650-65	202,010	1675-65	30,331
1651-65	6,483	1676-65	7,442
1652-65	853	1677-65	267,031
1653-65	324,064	1678-65	22,532
1655-65	609,461	1679-65	16,185
1656-65	100,491	1680-65	138,723
1657-65	66,903	1681-65	73,964
1658-65	13,225	1682-65	17,845
1659-65	3,854	1683-65	11,202
1660-65	7,129	1684-65	7,573
1661-65	2,926	1685-65	12,412
1662-65	43,681	1686-65	51,470
1663-65	1,951	1687-65	18,781

Docket No.	Amount Allocated
1688-65	$ 8,981
1689-65	18,335
1690-65	8,210
1691-65	1,842
1692-65	12,321
1930-65	56,261
1931-65	155,035
1932-65	30,744
1933-65	47,908
1934-65	624,127
1965-65	2,138
1966-65	1,104,072
1967-65	370,770
1968-65	40,681
1969-65	18,002
1970-65	141,723
1975-65	1,819,742
1976-65	50,518
1977-65	4,724
1978-65	694,830
1979-65	335,392
1980-65	2,075
1981-65	197,656
1982-65	8,482
1983-65	347,704
2019-65	139,146
2020-65	7,696
2021-65	97,163
2022-65	873
2023-65	21,523
2024-65	185,970
2025-65	120,098
2026-65	2,704
2027-65	7,565,745
2033-65	72,741
2034-65	200,184
2035-65	1,179,757
2036-65	$ 361,941
2037-65	708,098
2038-65	229,473
2039-65	12,884
2040-65	215,344
2041-65	155,419
2099-65	630,645
5440-65	32,381,882
5500-65	19,107,529
6617-65	10,328,356
6814-65	1,795,314
6856-65	10,459
6858-65	13,030
6895-65	242,079
6926-65	5,839
6996-65	2,502,195
7011-65	1,062,031
2652-66	1,908,107
2653-66	1,739,473
2654-66	52,462
2655-66	124,574
2656-66	5,890
2657-66	73,439
2658-66	19,417
2659-66	13,376
2660-66	158,554
2661-66	29,453
2662-66	48,828
2663-66	37,354
2664-66	92,026
2665-66	5,298
2666-66	3,141
2667-66	33,062
2668-66	15,749
2669-66	70,831
2670-66	1,943
2671-66	8,576

Docket No.	Amount Allocated
2672-66	$ 21,371
2673-66	9,612
2674-66	17,378
2675-66	10,895
2676-66	35,520
2677-66	8,736
2678-66	38,995
2679-66	6,279
2680-66	11,329
2681-66	63,285
2682-66	15,963
2683-66	19,983
2684-66	12,399
2685-66	77,650
2686-66	8,375
2687-66	31,359
2688-66	85,800
2689-66	57,269
2690-66	31,920
2691-66	122,214
2692-66	156,758
2693-66	8,505
2694-66	23,497
2695-66	359,562
2696-66	135,984
2697-66	976
2699-66	67,408
2700-66	279,449
2701-66	463,417
2702-66	58,581
2703-66	4,816
2704-66	18,667
2705-66	99,424
2706-66	4,748
2707-66	167
2708-66	48,478
2709-66	51,859
2710-66	$ 22,203
2711-66	56,950
2712-66	8,904,481
2713-66	102,736
2767-66	18,254
2768-66	133,553
2769-66	83,272
2770-66	289,835
2771-66	264,756
2772-66	135,747
2773-66	2,283
2774-66	36,701
2775-66	76,277
2776-66	403,156
2777-66	39,841
2778-66	131,205
2779-66	21,263
2780-66	27,609
2781-66	29,779
2782-66	15,762
2783-66	18,567
2784-66	17,559
2785-66	9,911
2786-66	16,286
2787-66	13,027
2788-66	19,076
2789-66	76,675
2790-66	4,610
2791-66	6,240
2793-66	55,855
2794-66	22,681
2822-66	182,817
2823-66	19,293
2824-66	141,570
2825-66	303,274
2826-66	37,419
2827-66	12,288

Docket No.	Amount Allocated
2853-66	$ 18,641
2854-66	26,704
2855-66	265,287
2857-66	15,207
2858-66	56,027
2859-66	13,692
2861-66	11,277
2862-66	73,277
2864-66	137,776
2865-66	4,119
2866-66	238,803
4993-66	17,118,117
6340-66	2,640,875
1197-67	1,047,490
1225-67	1,246,021
1226-67	1,816,714
1227-67	2,276,309
5004-67	866
5992-67	20,903
5993-67	1,400
5994-67	10,856
5995-67	3,705
5996-67	5,007
5997-67	2,150
5998-67	3,618
5999-67	1,630
6000-67	4,248
6001-67	2,693
6002-67	5,636
6003-67	2,313
6005-67	5,909
6006-67	1,834
6007-67	3,546
6008-67	9,094
6009-67	2,794
6010-67	1,986
6011-67	2,164

Docket No.	Amount Allocated
6012-67	$ 3,717
6013-67	2,521
6014-67	1,245
6015-67	2,027
6016-67	2,507
6017-67	2,415
6018-67	1,960
6019-67	564
6020-67	7,609
6021-67	2,359
6022-67	3,812
6023-67	2,861
6024-67	4,719
6025-67	2,956
6026-67	2,422
6027-67	5,591
6028-67	3,315
6029-67	3,688
6030-67	1,997
6031-67	9,793
6032-67	3,253
6033-67	1,883
6034-67	4,476
6035-67	4,101
6036-67	4,602
6037-67	713
6038-67	5,142
6039-67	991
6040-67	1,671
6041-67	3,710
6042-67	9,376
6043-67	1,972
6044-67	3,834
6045-67	3,775
6046-67	3,570
6047-67	3,536
6048-67	1,673

Docket No.	Amount Allocated	Docket No.	Amount Allocated
6049-67	$ 973	6086-67	$ 5,024
6050-67	1,930	6087-67	1,531
6051-67	3,326	6088-67	9,889
6052-67	2,980	6089-67	1,838
6053-67	1,678	6090-67	1,668
6054-67	1,310	6091-67	1,470
6055-67	2,241	6092-67	2,916
6056-67	2,785	6093-67	3,417
6057-67	6,283	6094-67	3,500
6058-67	1,946	6095-67	4,387
6059-67	15,845	6096-67	3,746
6060-67	4,854	6097-67	6,010
6061-67	2,115	6098-67	2,227
6062-67	777	6099-67	1,007
6063-67	1,649	6100-67	6,898
6064-67	5,090	6101-67	1,985
6065-67	2,078	6102-67	4,916
6066-67	4,676	6103-67	3,937
6067-67	3,042	6104-67	2,297
6068-67	4,995	6105-67	10,641
6069-67	3,861	6106-67	4,945
6070-67	2,210	6107-67	8,036
6071-67	1,359	6108-67	14,090
6072-67	4,067	6109-67	4,495
6073-67	1,730	6110-67	2,588
6074-67	3,055	6111-67	3,846
6075-67	1,197	6112-67	5,251
6076-67	952	6113-67	2,573
6077-67	4,259	6114-67	2,960
6078-67	3,731	6115-67	5,730
6079-67	12,124	6116-67	7,166
6080-67	2,214	6117-67	2,301
6081-67	4,272	6118-67	3,904
6082-67	2,968	6119-67	3,718
6083-67	1,149	6120-67	5,631
6084-67	4,109	6121-67	6,405
6085-67	2,857	6122-67	2,001

Docket No.	Amount Allocated
6123-67	$ 3,522
6124-67	1,671
6125-67	3,301
6126-67	1,165
6127-67	1,328
6128-67	3,860
6129-67	8,725
6130-67	2,567
6131-67	3,453
6132-67	4,057
6133-67	1,357
6134-67	2,688
6135-67	1,530
6136-67	2,674
6137-67	5,201
6138-67	786
6139-67	7,634
6140-67	5,553
6141-67	7,397
6142-67	2,266
6143-67	1,758
6144-67	1,015
6145-67	3,702
6146-67	2,017
6147-67	4862
6148-67	1,668
6149-67	2,894
6150-67	1,989
6151-67	1,265
6152-67	5,645
6153-67	2,939
6154-67	3,989
6155-67	1,655
6156-67	4,947
6157-67	2,695
6158-67	3,580
6159-67	7,489
6160-67	$ 10,319
6161-67	8932
6162-67	10,091
6163-67	8,778
6164-67	15,838
6165-67	5,379
6166-67	10,882
6167-67	3,435
6168-67	9,128
6169-67	104
6170-67	11,540
6171-67	10,754
6172-67	7,994
6173-67	6,596
6174-67	8,576
6175-67	3,385
6176-67	3,703
6177-67	3,922
6178-67	5,535
6179-67	8,816
6180-67	8,054
6181-67	7,749
6182-67	9,644
6183-67	5,918
6184-67	14,700
6185-67	2,444
6186-67	2,050
6187-67	4,947
6188-67	24,618
6189-67	6,814
6190-67	11,241
6191-67	2,380
6192-67	2,400
6193-67	12,642
6194-67	3,959
6195-67	8,796
6196-67	7,445

Docket No.	Amount Allocated
6197-67	$ 17,432
6198-67	3,389
6199-67	12,450
6200-67	5,086
6201-67	44,060
6202-67	10,703
6203-67	10,533
6204-67	824
6205-67	11,232
6206-67	8,205
6207-67	8,198
6208-67	11,805
6209-67	9,360
6210-67	1,666
6211-67	4,190
6212-67	6,046
6213-67	7,423
6214-67	10,392
6215-67	8,579
6216-67	2,947
6217-67	2,200
6218-67	7,179
6219-67	10,177
6220-67	7,897
6221-67	38,662
6222-67	1,899
6223-67	1,693
6224-67	7,268
6225-67	5,902
6226-67	4,927
6227-67	10,568
6228-67	3,194
6229-67	4,483
6230-67	4,618
6231-67	5,405
6232-67	25,193
6233-67	11,020

Docket No.	Amount Allocated
6234-67	$ 11,020
6235-67	4,923
6236-67	4,203
6237-67	5,135
6238-67	2,491
6239-67	1,786
6240-67	3,170
6241-67	2,395
6242-67	1,849
6243-67	2,595
6244-67	2,326
6245-67	2,234
6246-67	1,979
6247-67	1,104
6248-67	16,375
6249-67	1,019
6250-67	9,449
6251-67	10,550
6252-67	6,966
6253-67	7,516
6254-67	7,617
6255-67	2,238
6256-67	12,910
6257-67	3,555
6258-67	22,997
6259-67	16,885
6260-67	7,498
6261-67	790
6262-67	1,948
6263-67	8,582
6264-67	13,031
6265-67	5,570
6266-67	6,157
6267-67	7,128
6268-67	4,188
6269-67	4,052
6270-67	4,053

Docket No.	Amount Allocated
6271-67	$ 3,476
6272-67	4,959
6273-67	6,080
6274-67	4,729
6275-67	5,062
6276-67	30,486
6277-67	22,997
6278-67	45,270
6279-67	14,937
6280-67	14,457
6281-67	59,329
6282-67	32,549
6283-67	1,598
6284-67	336
6285-67	1,240
6286-67	1,093
6287-67	948
6288-67	401
6289-67	478
6290-67	1,002
6291-67	1,393
6292-67	3,501
6293-67	1,693
6294-67	3,451
6295-67	1,067
6296-67	1,505
6297-67	1,514
6298-67	1,644
6299-67	1,513
6300-67	3,342
6301-67	1,040
6302-67	981
6303-67	5,208
6304-67	1,901
6305-67	784
6306-67	690
6307-67	1,941
6308-67	$ 469
6309-67	1,953
6310-67	2,002
6311-67	476
6312-67	806
6313-67	846
6314-67	1,289
6315-67	2,173
6316-67	1,532
6317-67	1,421
6318-67	3,418
6319-67	581
6320-67	1,083
6321-67	670
6322-67	900
6323-67	1,695
6324-67	1,490
6325-67	1,492
6326-67	1,673
6327-67	773
6328-67	4,023
6329-67	9,332
6330-67	5,375
6331-67	2,319
6332-67	8,353
6333-67	14,126
6334-67	7,545
6335-67	12,037
6336-67	15,395
6337-67	12,118
6338-67	9,504
6339-67	7,452
6340-67	7,808
6341-67	51,024
6342-67	42,663
6343-67	35,391
6344-67	7,470

Docket No.	Amount Allocated	Docket No.	Amount Allocated
6345-67	$ 6,270	389-68	$ 18,454
6346-67	2,068	390-68	110,271
6347-67	697	391-68	78,461
6348-67	4,845	392-68	85,811
6349-67	5,148	393-68	7,005
6350-67	32,077	2334-68	321,390
6351-67	8,512	2335-68	60,340
6352-67	9,148	2336-68	9,236
6353-67	9,605	2337-68	11,422
6354-67	5,590	2338-68	29,701
6355-67	5,260	2339-68	39,651
6356-67	1,661	2340-68	14,854
6357-67	8,583	2341-68	30,383
6358-67	1,923	2342-68	16,623
6359-67	7,767	2343-68	12,306
6360-67	7,536	2344-68	24,556
6361-67	6,134	2345-68	25,646
6362-67	7,780	2346-68	13,833
6363-67	17,393	2347-68	77,567
6364-67	9,186	2348-68	1,720,579
6365-67	9,658	2349-68	87,185
6366-67	15,628	2350-68	257,389
6367-67	2,591	2351-68	257,389
6368-67	16,577	2352-68	37,435
6369-67	2,390	2353-68	37,435
6370-67	12,546	2354-68	114,803
6371-67	25,491	2355-68	114,803
6372-67	51,114	2356-68	114,803
6373-67	1,529	2357-68	78,815
6374-67	943	2358-68	248,970
6375-67	514	2359-68	1,268,994
6387-67	1,088,877	2360-68	1,268,994
384-68	756,517	2361-68	58,811
385-68	239,603	2389-68	27,744
386-68	31,964	2390-68	17,399
387-68	243,628	2391-68	7,022
388-68	82,485	2392-68	5,375

Docket No.	Amount Allocated
2393-68	$ 13,232
2394-68	16,905
2396-68	23,352
2397-68	11,467
2398-68	31,972
2399-68	21,101
2400-68	22,885
2468-68	417
2471-68	72,052
2472-68	10,459
2473-68	17,883
2479-68	78,028
2480-68	3,077
2481-68	3,077
2482-68	3,077
2483-68	3,077
2484-68	3,077
2485-68	3,077
2486-68	3,077
2487-68	3,077
2488-68	3,077
2489-68	3,077
2490-68	3,077
2491-68	3,077
2492-68	3,077
2493-68	3,077
2494-68	3,077
2495-68	3,077
2496-68	3,077
2497-68	3,077
2498-68	3,077
2499-68	3,077
2500-68	3,077
2501-68	3,077
2502-68	3,077
2503-68	3,077
2504-68	647,596
2505-68	$ 13,249
4432-68	26,278
5653-68	2,571,793
5656-68	2,148,724
5657-68	124,900
5663-68	41,808
5664-68	49,350
5665-68	74,634
5666-68	66,848
5669-68	283,160
5670-68	108,088
5671-68	29,082
5673-68	37,162
5674-68	29,238
5675-68	48,268
5676-68	15,540
5677-68	30,902
5678-68	93,170
5679-68	116,688
5680-68	25,330
5681-68	28,122
5682-68	66,256
5683-68	9,840
5684-68	13,546
5685-68	42,366
5686-68	34,724
5688-68	108,066
5689-68	93,080
5690-68	9,452
5692-68	42,638
5693-68	11,126
5694-68	37,216
5695-68	62,346
5696-68	28,384
5697-68	33,890
5698-68	30,178
5699-68	31,128

Docket No.	Amount Allocated	Docket No.	Amount Allocated
5700-68	$ 23,580	1019-69	$ 4,180
5701-68	101,726	1020-69	17,318
5702-68	49,496	1021-69	12,608
5703-68	16,944	1022-69	76,548
5704-68	32,446	1023-69	19,461
5705-68	20,852	1024-69	10,056
5708-68	104,524	1025-69	13,182
5709-68	18,148	1026-69	16,108
5710-68	20,930	1027-69	29,765
5712-68	39,894	1028-69	14,422
5713-68	33,500	1029-69	31,855
5714-68	48,692	1030-69	14,304
5715-68	7,652	1031-69	24,957
5716-68	152,804	1032-69	15,324
5717-68	21,618	1033-69	11,195
5718-68	57,590	1034-69	15,657
5719-68	27,272	1035-69	4,868
5721-68	18,392	1036-69	6,422
5722-68	37,922	1037-69	7,729
5723-68	12,454	1038-69	10,274
5724-68	229,926	1039-69	10,544
5725-68	15,100	1040-69	15,279
5726-68	18,516	1041-69	7,040
5727-68	23,026	2222-69	51,757
5728-68	15,552	2223-69	64,471
5729-68	10,686	2224-69	143,352
5733-68	254,044	2225-69	261,730
5734-68	330,310	2226-69	43,658
1010-69	24,958	2227-69	332,779
1011-69	14,370	2228-69	194,528
1012-69	17,223	2229-69	46,818
1013-69	11,101	2230-69	34,551
1014-69	8,236	2231-69	90,855
1015-69	71,723	2232-69	45,259
1016-69	12,949	2233-69	1,944
1017-69	16,859	2234-69	17,651
1018-69	13,318	2235-69	54,983

Docket No.	Amount Allocated
2236-69	$ 52,704
2237-69	28,449
2238-69	2,025
2239-69	74,297
2240-69	6,708
2241-69	37,192
2242-69	51,277
2243-69	4,730
2244-69	86,054
2245-69	6,719
2246-69	72,126
2247-69	78,430
2248-69	46,925
2249-69	87,828
2250-69	1,685
2251-69	100,124
2252-69	26,854
2253-69	9,098
2254-69	84,069
2255-69	98,131
2256-69	36,080
2257-69	92,788
2258-69	22,612
2259-69	3,393
2260-69	32,945
2261-69	29,326
2262-69	39,745
2263-69	79,764
2264-69	284,380
2265-69	66,109
2266-69	9,734
2267-69	96,576
2268-69	32,897
2269-69	25,596
2270-69	10,303
2271-69	$ 1,209
2272-69	25,940
2273-69	3,752
2274-69	8,652
2275-69	6,223
2276-69	58,113
2277-69	14,799
2278-69	5,167
2279-69	3,014
2280-69	44,878
2432-69	81,422
2434-69	261,181
2435-69	145,237
2436-69	705,050
2437-69	248,345
2438-69	192,391
2439-69	7,489
2440-69	172,391
2441-69	24,552
2442-69	417,237
2443-69	40,686
2444-69	13,771
2445-69	58,558
2446-69	255,295
2447-69	48,179
2448-69	640,377
2449-69	304,696
2450-69	277,135
2451-69	97,880
2452-69	107,059
2453-69	7,746,895
2455-69	27,368
2456-69	154,054
3105-69	17,973,301

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IP-65-C No. 262	$481,814
IP-68-C No. 203	36,579
IP-68-C No. 204	3,023
IP-68-C No. 205	21,587
IP-68-C No. 206	215,543
IP-68-C No. 207	24,079
IP-68-C No. 208	27,017
IP-68-C No. 209	22,366
IP-68-C No. 210	4,791
IP-68-C No. 211	5,468
IP-68-C No. 212	20,565
IP-68-C No. 213	30,441
IP-68-C No. 214	27,259
IP-68-C No. 215	11,491
IP-68-C No. 216	33,744
IP-68-C No. 217	28,921
IP-68-C No. 220	12,947
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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 561

LOCAL FINANCE CORPORATION, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis for this Court's jurisdiction are as set forth in the petition and in the Commissioner's protective petition in *Commissioner* v. *Guardian Agency, Inc. and Beneficial Insurance Agency*, No. 390, pending this Term.

QUESTION PRESENTED

Whether, in the particular circumstances of this case, the Commissioner's allocation to Local Finance Corporation and its subsidiaries, pursuant to Section 482 of the Internal Revenue Code of 1954, of one-

half of the income from credit life insurance premiums paid by their borrowers to corporations controlled by their shareholders, was correctly sustained by both courts below as neither arbitrary nor unreasonable.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the petition at pp. 3-5.

STATEMENT

This is a consolidated income tax case for the years 1958 through 1962 involving Section 482 of the Internal Revenue Code. Section 482 empowers the Commissioner of Internal Revenue to allocate income among business enterprises controlled by the same interests "if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such * * * businesses." Petitioners are a parent corporation and its wholly-owned subsidiaries all of which operated as finance companies in Indiana. Stockholders who owned in excess of 70 percent of the stock of petitioner Local Finance Corporation (the parent finance company), owned 100 percent of Guardian Agency, Inc. ("Guardian"), a general insurance broker. Beneficial Insurance Agency, Inc. ("Beneficial") is the wholly-owned subsidiary of Guardian. (Pet. (No. 390) App. A 8-9.)[1]

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[1] "Pet. (No. 390)" references are to the Commissioner's protective petition for certiorari in *Commissioner* v. *Guardian Agency, Inc. and Beneficial Insurance Agency, Inc.*, No. 390, pending this Term.

In connection with the loans made by petitioners, single premium credit life insurance was offered to their borrowers. The insurance was sold by petitioners' employees who prepared the necessary papers. Before 1954, the insurance was issued by an independent life insurance company which retained (after payment of death claims and expenses) 9.5 percent of the premiums and paid Guardian a commission roughly equal to one-half of the premiums. Beginning in January, 1954, the commissions were paid to an officer of Guardian who assigned the commission income to Guardian which, together with Beneficial and Local Finance, performed most of the accounting duties incident to the sale of the insurance. After adjustments for contingent commissions, Guardian retained approximately 56 percent of the premiums. (Pet. (No. 390) App. A. 9-10).

After June 30, 1958, a new arrangement was devised whereby Grand National Life Insurance Company ("Grand National") was organized under the laws of Arizona. Ninety-nine percent of the stock of Grand National was owned by shareholders of Guardian. Grand National thereupon entered into a reinsurance agreement with the independent insurance company which had previously issued the credit life insurance for borrowers from Local Finance. This reinsurance agreement provided that Grand National was to pay death claims out of the 90.5 percent of the premiums it was to receive; the independent insurer was to receive the remaining 9.5 percent of the premiums. Under the new arrangement, there was little or no change in the procedures

followed in the sale of credit life insurance by the petitioner finance companies. Employees of Local Finance and its subsidiaries continued to sell the insurance and prepare the necessary papers, and employees of Guardian and Beneficial continued to perform certain of the accounting duties incident to the sale of the insurance. Grand National conducted no activity other than contracting for reinsurance of the credit life insurance. It had no salaried employees other than an attorney who served as office manager for $20 per month. Its office consisted of space in a room in the law offices of its office manager. As under the previous arrangement, the supervision and payment of all claims were handled by the independent insurance company. During the period July 1, 1958, to December 31, 1962, Grand National retained about 58 percent of the total premiums after the payment of death claims and expenses. A substantial portion of the retained amounts were paid as dividends to its shareholders, who owned in excess of 70 percent of the stock of petitioner finance companies. (Pet. (No. 390) App. A 10; App. C 36, 39.)

Acting under Section 482, the Commissioner allocated one-half of the premium income to petitioner and its subsidiaries for the period January 1, 1958, to December 31, 1962, and determined deficiencies accordingly. This allocation was premised on the theory that this portion of the premiums constituted compensation actually earned by petitioner finance companies for selling and processing the credit life insurance. (Pet. (No. 390) App. A 10-11.) For

protective purposes, the Commissioner alternatively asserted deficiencies against Guardian and Beneficial by means of a similar allocation of premium income, for the period July 1, 1958, to December 31, 1962 (Pet. (No. 390) App. C 40-41).[2]

Both the Tax Court (Pet. (No. 390) App. C 20-63) and the court of appeals (Pet. (No. 390) App. A 7-18) upheld the Commissioner's primary determination that one-half of the premium income was allocable to petitioner finance companies. Accordingly, they had no occasion to consider the Commissioner's alternative allocation to Guardian and Beneficial.[3]

ARGUMENT

The issue presented was correctly decided by both courts below. There is no conflict of decisions or any other basis for further review by this Court.

1. Section 482 of the 1954 Code provides that the Commissioner may "allocate gross income" between "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by

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[2] No allocation to Guardian and Beneficial was made with respect to the period January 1 to June 30, 1958, since those corporations had already included in their income the commissions received during that period (Pet. (No. 390) App. C 40-41).

[3] The alternative allocation is the subject of the protective petition for a writ of certiorari in *Commissioner* v. *Guardian Agency, Inc. and Beneficial Agency, Inc.*, No. 390, pending this Term. If the instant petition for certiorari is denied, the Commissioner will seek to have his protective petition dismissed pursuant to Rule 60

the same interests," "if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." The purpose of this provision is "to deny [taxpayers] the power to shift income * * * among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 216 (C.A. 2). In applying Section 482, the applicable standard is "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations Section 1.482-1(b)(1) (Pet. 4). Accordingly, the statute empowers the Commissioner to examine transactions between controlled taxable entities in order to determine whether they would have been consummated in arm's length negotiations between strangers and to make an allocation when they fail to meet that standard. *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 1000 (Ct. Cl.); *Oil Base, Inc.* v. *Commissioner*, 362 F. 2d 212, 214 (C.A. 9), certiorari denied, 385 U.S. 928; *Hall* v. *Commissioner*, 294 F. 2d 82 (C.A. 5); *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639 (C.A. 6).

Because the Commissioner has been given broad discretion to allocate income under Section 482, such a determination "is essentially one of fact and * * * must be affirmed if supported by substantial evidence." *Advance Machinery Exch.* v. *Commissioner*, 196 F. 2d 1006, 1007-1008 (C.A. 2). Given the broad power accorded the Commissioner under the statute, the courts have uniformly held that a Sec-

tion 482 allocation should not be set aside unless clearly shown to be unreasonable, arbitrary and capricious. *Spicer Theatre, Inc.* v. *Commissioner*, 346 F. 2d 704 (C.A. 6); *Rooney* v. *United States*, 305 F. 2d 681 (C.A. 9); *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 255, affirmed, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819. Further review of the factual question decided adversely to petitioners by the two courts below consequently is unwarranted. *Comstock* v. *Group of Investors*, 335 U.S. 211, 214; *Rudolph* v. *United States*, 370 U.S. 269, 271.

The evidence in this case amply supports the Tax Court's conclusion and the court of appeals' affirmance that, under the circumstances, "the Commissioner's allocation of only 50 percent of the net premiums to the * * * [petitioners was] reasonable" (Pet. (No. 390) App. A 13).[4] Common to the periods before and after July 1, 1958, is the undisputed fact that employees of the petitioners performed all of the services incident to the sale of the insurance. They wrote the policies, collected the premiums and deposited them in bank accounts of Guardian and Beneficial, made refunds, prepared the necessary papers in the event of the death of an insured debtor, and made weekly reports to Guardian and Beneficial, which collated and transmitted information and pre-

[4] Because of the interlocking relationship among petitioners, Guardian and Grand National, there is no doubt, and petitioners do not contest the fact, that these corporations were controlled by the same interests within the meaning of Section 482.

miums to the independent insurer. Since it is common industry practice for life insurance companies to pay commissions to a lender which performs such services, petitioners would have received commission income in any arm's length arrangement.[5] The formal diversion of this commission income to Guardian and Grand National, first by the assignment and then by the reinsurance arrangement, scarcely can mask the fact that petitioners earned this income, controlled its disposition, and continued to benefit from it through the interlocking shareholder relationship of the various corporate entities. Indeed, the use of Section 482 in a so-called "captive insurance company" case like this one was specifically approved by Congress in connection with the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36. Both of the Congressional Committees observed that Section 482 provided the Commissioner with "ample regulative authority to deal with this problem." S. Rep. No. 1571, 84th Cong., 2d Sess., p. 8 (1956-1 Cum.

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[5] Petitioners' assertion (Pet. 15) that their income would not have been any greater if Guardian and Grand National were unrelated corporate entities dealing with them at arm's length and that the Tax Court made no finding to the contrary cannot stand analysis. The Tax Court specifically found that a portion of the reinsurance premiums received by Grand National (Pet. (No. 390) App. C 49) "in reality constituted commission income which the finance companies had earned and which they gratuitously diverted to [Grand] National." This finding was supported by the testimony of an officer of the independent insurer who stated that (Pet. (No. 390) App. C 49 n. 15) "one of the purposes [of the reinsurance arrangement] was to create a legal vehicle to enable us to pay compensation in connection with the procurement of the insurance."

Bull. 967, 971-972); H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7 (1956-1 Cum. Bull. 954, 958). Since Guardian received 56 percent of the premiums from January 1 to June 30, 1958, and Grand National received 58.4 percent of the premiums (of which 8.4 percent was found to constitute adequate compensation for the reinsurance risk) for the subsequent period, the Commissioner's allocation of 50 percent of the premiums to petitioners was in accord with the substance of the transaction and was eminently reasonable.[6]

2. Petitioners' principal contention (Pet. 11-14) is that because Indiana law appears to have precluded them from receiving commission income from credit life insurance,[7] the Commissioner's allocation under Section 482 was unreasonable. It is firmly established, however, that unless a federal taxing statute is dependent upon state law, federal criteria are to be applied in determining tax consequenecs under that statute. *Burnet* v. *Harmel*, 287 U.S. 103, 110; *Lyeth* v. *Hoey*, 305 U.S. 188, 194; *Morgan* v. *Com-*

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[6] Considerable tax savings were realized by having this commission element of the net premiums reported as the income of Grand National because it enjoyed the favorable tax treatment granted insurance companies. See Sections 802(a), 804, 809, and 815, Internal Revenue Code of 1954. The findings of the Tax Court indicate (Pet. (No. 390) App. C 39) that Grand National's effective tax rate on the gross premiums received during the years involved averaged approximately 20 percent.

[7] Indiana law apparently forbids finance companies from receiving any income other than interest from loans (see 5 Burns Indiana Statutes Annotated, Sec. 18-3002), but there has been no judicial interpretation of this statute.

missioner, 309 U.S. 78, 80; *cf. Biddle* v. *Commissioner*, 302 U.S. 573, 578-579. The crucial question under Section 482 has nothing whatever to do with state law. It is whether petitioners, Guardian, and Grand National would have entered into the same arrangements had they been uncontrolled corporations dealing at arm's length. Clearly, as both courts below held (Pet. (No. 390) App. A 12-14, App. C 46-50), petitioners would not have allowed an independent third party to retain approximately 58 percent of the premium income, as did Guardian and Grand National. The only reason that such an arrangement was countenanced by petitioners was because Guardian and Grand National were commonly controlled corporate entities. The fact that the arrangements devised by petitioners might have satisfied the requirements of Indiana law by circumventing the prohibition against direct receipt by petitioners of commission income does not prevent the Commissioner from exercising his prerogative under Section 482 and allocating income to the corporate entities which in fact earned it to reflect income clearly. Cf. *National Securities Corp.* v. *Commissioner*, 137 F. 2d 600, 602 (C.A. 3).

Contrary to petitioners' suggestion (Pet. 13), there is no analogy between this case and *Poe* v. *Seaborn*, 282 U.S. 101. First, *Seaborn* did not involve the plenary power granted the Commissioner under Section 482. Second, the state laws applicable in the two cases are wholly different. In *Seaborn*, Washington's community property law provided that a wife was the owner of one-half of her husband's

income, whether or not her efforts contributed to the earning of that income. The Indiana statute upon which petitioners rely did not, as the community property law did in *Seaborn*, affirmatively vest the commission income in Guardian and Grand National. The latter received this income not as a matter of law but only as a result of petitioners' contractual arrangements which diverted such income to them.* *Cf. Lucas* v. *Earl*, 281 U.S. 111; *Kimbrell* v. *Commissioner*, 371 F. 2d 897, 902 (C.A. 5). The possibility that petitioners may not have been able to assert valid title to the income under state law should not control the tax consequences of the transactions, since "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers*, 281 U.S. 376, 378. Whatever success the parties may have achieved in satisfying the formal requirements of local law, the commission element of the premiums was earned by and was, in substance, under the control of petition-

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* *L. E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T.C. 940 (Pet. 16-17), also is distinguishable. In that case, the Tax Court held that an allocation under the predecessor provisions of Section 482 was improper because the price charged by the taxpayer to a controlled buyer was fixed by O.P.A. limits. Unlike the situation in *Shunk*, where the taxpayer charged its controlled buyer the same price it would have charged an unrelated buyer, the courts below found on the facts of this case that the arrangements made by petitioners with respect to premium income would not have been made with independent third parties. In short, it was the fact that the O.P.A. price in *Shunk* was the *de jure* arm's length price that rendered Section 482 inapplicable.

ers because shareholders owning in excess of 70 percent of the stock of Local Finance owned 99 and 100 percent of the stock of Grand National and Guardian, respectively.[9]

The significance of this common control is graphically underscored by the fact that substantial dividends ($267,044) were paid by Grand National to its shareholders (essentially the shareholders of Local Finance) during the years involved (Pet. (No. 390) App. C 39). While the interlocking relationship devised might have been necessary and sufficient to pass muster under the Indiana statute, the very fact of common control of the corporate parties caused the arrangements in question to be scrutinized under Section 482—the purpose of which is to insure that transactions among controlled businesses are treated in accordance with their substance and not with their form. To permit Indiana law to dictate the outcome of this case, as petitioners urge, would compel the Commissioner to accord substantive tax reality to arrangements which petitioners devised only to comply with state law requirements based on policy considerations wholly different from those of Section 482. Both courts below thus were correct in refusing to hold such state law considerations controlling.

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[9] Petitioners claim (Pet. 21-22) that Section 482 is inapplicable because they were in a position to earn commissions and simply chose not to do so. The courts below specifically found, however, that petitioners did indeed earn the income allocated to them by the Commissioner because their employees sold and processed the policies (Pet. (No. 390) App. A 14, App. C 46-47).

3. None of the authorities cited by petitioners (Pet. 16-22) are in conflict with the decision below. In many of those cases, an individual corporate officer, rather than the corporation itself, was found to have earned commission income.[10] In others, the Commissioner's determination was not premised upon a Section 482 allocation.[11] While both *Nichols Loan Corp. of Terre Haute* v. *Commissioner*, 321 F. 2d 905 (C.A. 7), reversing decision of June 22, 1962 (21 T.C.M. 805), and *Campbell County State Bank, Inc. of Herreid, S.D.* v. *Commissioner*, 311 F. 2d 374 (C.A. 8) (Pet. 20), involved similar sales of credit life insurance, there was no finding in *Nichols* that the controlled insurance company had not earned the commissions and no reference to Section 482 in the opinion of the Tax Court or that of the Seventh Circuit. Similarly, there was no finding in *Campbell* that the finance companies earned commission income

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[10] *Moke Epstein, Inc.* v. *Commissioner*, 29 T.C. 1005; *Ray Waits Motors* v. *United States*, 145 F. Supp. 269 (E.D. S.C.); *Gaddy Motor Co., Inc.* v. *Commissioner*, decided October 31, 1958 (27 T.C.M. 815); *Jaegar Motor Car Co.* v. *Commissioner*, 284 F. 2d 127 (C.A. 7), certiorari denied, 365 U.S. 860; *Crowley* v. *Commissioner*, 34 T.C. 333; and *Alabama-Georgia Syrup Co.* v. *Commissioner*, 36 T.C. 747, reversed on another issue *sub nom. Whitfield* v. *Commissioner*, 311 F. 2d 640 (C.A. 5). (Pet. 20, 22.)

[11] *Teschner* v. *Commissioner*, 38 T.C. 1003; *Alinco Life Insurance Co.* v. *United States*, 373 F. 2d 336 (Ct. Cl.); *First Security Bank* v. *United States*, 213 F. Supp. 362 (Mont.), affirmed, 334 F. 2d 120 (C.A. 9); and *First State Bank* v. *United States* (S.D.), decided June 25, 1962 (62-2 U.S.T.C., par. 9613). (Pet. 13, 20, 21.)

by performing the services of selling and processing credit insurance.[12]

4. With respect to the administrative importance of this case, it is significant that petitioners, in their generalized assertion (Pet. 18-19) that a vast number of cases are pending in the courts concerning allocations of income among insurance companies, finance companies, and their shareholders, do not hazard any statement as to how those allocations relate to the decision below. Indeed, petitioners have presented an inflated and misleading list of pending cases. By citing docket numbers instead of cases (Pet. 24-36), petitioners show a pending "case" for each of the multiple parties for each taxable year. The amounts alleged to be in issue are similarly exaggerated since, by their own admission (Pet. 19), petitioners' figures include the alternative allocations made by the Commissioner to protect the revenues in the event that his primary allocation is not sustained. Moreover, petitioners' figures fail to reflect that the deficiencies arising from the Commissioner's allocations of commission income to finance companies

[12] There is also no basis for petitioners' contention (Pet. 19, n. 3, 4) that the decision below is in conflict with *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436; *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422; or *Gregory* v. *Helvering*, 293 U.S. 465. We do not quarrel with the general proposition that taxpayers are free to structure their business affairs in order to minimize their tax liability. But the transactions at issue could have been arranged so that Grand National's and Guardian's employees performed sufficient services to warrant payment of the commissions to those entities. The fact that they did not do so provides ample justification for the Commissioner's Section 482 allocation.

would be offset in part by reductions in the commission income of "captive insurance companies." In any event, measurement of the administrative importance ends, as it begins, not with petitioners' assertion (Pet. 22) that this case raises "some of the most difficult and fundamental issues in federal tax law," but rather with recognition that an essentially factual question is presented. Further review by this Court consequently is unwarranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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